An Economic Outlook

Greater Philadelphia Chamber of Commerce

Netrality Properties

Philadelphia, PA

April 12, 2016

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President and CEO
Federal Reserve Bank of Philadelphia

FEDERAL RESERVE BANK
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The views expressed today are my own and not necessarily
those of the Federal Reserve System or the FOMC.

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Introduction

Good morning. Thanks to Bob Kane for that kind introduction.

I would also like to thank the Greater Philadelphia Chamber of Commerce, particularly President and CEO Rob Wonderling, for inviting me here today. As someone who has spent most of his life in this region and believes firmly in the integral role of business in enabling communities to thrive, I deeply value the important work of the Greater Philadelphia Chamber of Commerce.

I am especially thrilled to note that my friend and former colleague John Fry will serve as the next chairman of the chamber, and I applaud that excellent choice.

Let me also acknowledge Emily Bittenbender, the recent recipient of the chamber's prestigious Paradigm Award. How wonderful and appropriate that this year's award honored someone in the construction field.

Emily has not only broken barriers, but she has opened doors and created countless job opportunities during her career. That is a subject I care deeply about and will discuss in a few minutes.

An Economic Outlook

Today I would like to offer my views on the outlook for the U.S. economy and monetary policy. As always, my views are mine alone and do not necessarily reflect those of my colleagues on the Federal Open Market Committee (FOMC) or anyone else in the Federal Reserve System.

After expressing my views on our nation's economic health and prospects, I would like to offer a few observations about our local economic landscape. I will concentrate on what I believe are the inherent strengths and challenges in the Greater Philadelphia economy as it relates to the construction and real estate sectors.

An Economic Snapshot

Despite a subdued fourth quarter when real GDP increased by 1.4 percent and a bumpy start to the year, I remain upbeat. Economic fundamentals are sound, and our financial system is in good shape. Labor markets remain dynamic, income growth is solid, and consumer spending continues to increase at a solid pace.

If there is anything that I believe would pose any risk to the forecast I will deliver, it would be the strong dollar and weakening growth in China. The effects that these developments may have on the U.S. economy are something that we continue to watch closely.

Equity Markets

Equity markets have been volatile, but despite the volatility, equity prices are pretty much where they started at the beginning of the year. Much of the volatility we have experienced is no doubt related to worries about the underlying strength in worldwide economic activity. This is especially the case with China and the continued negative impact of the strong dollar. Taken together, slower Chinese growth and the high value of the dollar create some downside risk to my assessment of future economic activity.

That said, since recent signs are pointing to a bottoming out in manufacturing activity and China is not our major trading partner, I remain optimistic that solid fundamentals will be the overriding determinant of future U.S. economic activity.

As a policymaker, I think it is important to take a long-term view rather than to react to short-term volatility and, thus, consider an array of data and longer-term trends in forming our policy stance. As I said, over the longer run, I am relatively optimistic.

Inflation

Let me now turn to another important component of the U.S. economy that significantly influences monetary policy, and that is inflation. This continued to run below the FOMC's 2 percent target in 2015. Both the fall in energy prices and, to a lesser extent, the appreciation of the dollar have held down headline inflation, or total inflation, which includes commodities such as food and energy prices.

Inflation measures that remove these more volatile components are not far from our goal of 2 percent. I believe that once energy prices stabilize and start reversing, inflation will return to our 2 percent target. I see headline inflation accelerating at an annual average pace of 1.5 percent by the second half of this year.

But as Fed Chair Janet Yellen has emphasized, inflation expectations are also a crucial ingredient in formulating monetary policy. She notes, "Convincing evidence that longer-run inflation expectations have moved lower would be a concern." This is because such expectations would make attaining our inflation target harder to achieve.

So far, survey evidence, like that obtained from the Philadelphia Fed's *Survey of Professional Forecasters*, does not indicate any unanchoring of inflation expectations. However, market-based measures are showing that investors are seeking less compensation for inflation. But there are downside risks to my baseline forecast. In particular, we have been below our inflation target for all but two years since 2008. Consistently below-target outcomes will eventually lead to a lack of credibility for our 2 percent goal. Hence, it may be worth erring on the side of accommodation to ensure against that outcome.

However, there are also risks to the upside. There is a good deal of anecdotal evidence that firms are planning to raise wages, especially for jobs that are proving to be hard to fill.

I do expect some faster wage growth going forward, and accelerating wage growth could translate into more robust inflation. Additionally, it is unlikely that oil prices will continue to drop, and eventually, they will contribute rather than detract from inflation.

Monetary Policy

My approach to policy is to conduct it in ways that will best serve our dual mandate of maximum employment and price stability. Given the behavior of oil prices, inflation is likely to be quite low in the first quarter of the year, probably even negative. Regarding the employment side of our mandate, I believe we will attain our goal early this year, if we have not attained it already.

Over the medium term, I remain confident that inflation will return to target. Math is in our favor: Energy prices would need to fall again and, by a similar magnitude, to renew their downward pressure on inflation. In other words, even if energy prices remain at very low levels, inflation should naturally rebound as current prices become the base upon which price increases are computed.

Similarly, import prices should stabilize as the dollar does, removing another source of downward pressure on inflation. Granted, this process will take some time as the price cuts are transmitted across the economy.

Although I remain confident that inflation will return to the Committee’s 2 percent target, my outlook sees it doing so only gradually. As I mentioned before, global headwinds point to some downside risks to my economic outlook.

These considerations make me a bit more conservative in my approach to policy, at least in the very near term. Although I cannot give you a definitive path for how policy will evolve, it might prove prudent to wait until the inflation data are stronger before we undertake a second rate hike. So, I am approaching near-term policy more cautiously than I did a few months ago. That is part of being data dependent.

And attentiveness to the data will be a key factor in all of my future policy recommendations as well. If financial headwinds dissipate quickly and inflation picks up a bit more aggressively, it will require a slightly more aggressive approach to policy.

I believe as we move into the second half of the year with economic activity growing at trend or slightly above trend, the unemployment rate below its natural rate, and price pressures starting to assert themselves, policy can truly normalize. I mean this in the sense that we can move away meaningfully from the zero lower bound and that our reaction to incoming data can return to a more historical pattern.

That would not necessarily imply an overly aggressive path for policy. Thus, it will take fewer rate hikes to attain neutrality in policy than it would have 15 years ago. By historical standards, that in itself implies a somewhat shallower path for interest rates than was typical of past recoveries.

Real Estate

Looking at real estate in more detail, residential investment is an emerging bright spot for the national economy as growth in this sector is currently well above its historical average. The demand for housing has picked up, and prices of houses and especially rentals are growing strongly.

While much of the initial real estate gains were in multifamily units, which remains robust, new single-family homes have also started to accelerate more noticeably over the past year or so. This is a national trend we saw happen first in cities such as New York and San Francisco already. Now Philadelphia is seeing this same kind of urban gentrification.

Much has been written about the influx of millennials to Center City as well as the challenges of keeping them here. Good schools, jobs, and competitive tax structures are critical.

Since 1992, census data show a dramatic rise in the proportion of urban versus suburban housing construction. We looked at Philadelphia and seven surrounding counties over the past few decades:

- From 2013 through 2015, nearly 40 percent of all residential building permits were in the cities of Philadelphia and Camden.
- This is a significant shift since the building permits were as low as 2 percent in 1992.
- In fact, all urban residential building permits never climbed above 8 percent in the entire period between 1988 and 2002.

This residential growth has been accompanied by office growth as well. This has boosted both an improving daytime and nighttime population, which creates a vibrant city on a 24-hour basis.

According to the Center City District and Central Philadelphia Development Corporation, the average household income for core Center City residents is more than $100,000. This has increased the demand for retail and is prompting the development of other sites on Market East.

Other highlights include:

- The $1.2 billion Comcast Innovation & Technology Center, the largest planned project in the city's history;
- Drexel University and Brandywine Realty Trust's recently announced the 8-million-square-foot Schuylkill Yards mixed-use project;
- The Navy Yard, which just celebrated its 10th anniversary with close to 12,000 workers, and is breaking ground on its 14th new office building;
- And finally, the $800 million urban center slated for Camden's waterfront. I won't go into detail because I know the CEO of Liberty Property Trust is going to speak today. But I am particularly excited about the vision of this project and how it will create a new daytime workforce and new jobs for city residents.

I toured Camden last week with Mayor Dana Redd as part of a larger discussion on community revitalization. It is wonderful to see the recent shift in momentum there. These are just a few projects that show how this region — and its cities in particular — are seeing an increase in demand for urban, residential, and mixed-use development.

Despite our region's recent growth, we are seeing little evidence of widespread construction-related cost pressures for either materials or labor.

Weak global demand has been driving energy and commodity prices lower this past year. In fact, material costs have fallen as a result as well as the cost of transporting these supplies.

As long as current global market conditions remain, I do not anticipate any significant movement in these prices in 2016. I expect construction costs to increase at or below that of the general economy in the near term. Further, labor costs are generally rising in step with that of the general economy.

Employment

Let me now focus more closely on the labor market, employment opportunities, and workforce development issues for the nation and our region.

I am fortunate to have joined the Fed at a time when our business climate maintains a steady and gradual improvement, and though challenges remain, we continue making strides. Robust employment growth, increased disposable income, and fairly healthy household balance sheets should cause consumption to grow this year by 2.7 percent, and it is the consumer who will underpin the economic progress in my forecast.

One of the fundamental strengths supporting this economic growth will be the continued strength in job growth. Each of the past three years has witnessed the creation of more than 2 million net new jobs, and many of those jobs were in highly skilled professions.

Although I expect that employment growth will slow somewhat, I am still expecting a year in which the economy creates in the neighborhood of 2 million net new jobs. We are well on pace to reach this target as monthly job gains have averaged 209,000 for the first three months of the year.

The number of job openings nationally remains above prerecession levels, and in my meetings around the District, I often hear employers lament about the difficulty in finding the right workers. While recruiting and attracting talent is becoming more challenging for many of your organizations, it is also a sign of the steady improvements and resiliency of our labor markets.

The rate of workers voluntarily leaving their jobs — another key indicator of how people view their own employment prospects — has also recently reached prerecession levels. Due to this reduction in labor market slack, I anticipate stronger wage growth than the 2 percent or so that we achieved last year.

Workers returning to the labor force have also boosted the participation rate for three consecutive months, and we are now just shy of 63 percent. Our participation rate was hit hard by the recession, but it is a number that is also heavily influenced by demographics and social shifts as well as by the number of discouraged workers. For instance, in the 1960s and ’70s, women entered the workforce in greater numbers, so we saw the participation rate spike.

While 63 percent is still low by historical standards, the participation rate began trending down from its peak value of 67.3 in 2000 as baby boomers started their transition from work to retirement.

There’s no doubt that discouraged workers accelerated the participation rate drop we experienced in recent years; however, I feel any further reductions we could experience moving forward is more likely to be caused by retirements and school enrollment versus discouraged workers.

Although we experienced a small cyclical uptick in the March unemployment rate to 5.0 percent, I believe that the overall strength in job growth could bring the unemployment rate down to 4.7 percent by year-end.

So, what does this mean for you and other business leaders who I have spoken with who need trained workers to grow their businesses? It means that we must all take an active role in developing our future workforce. We have the people.

There are more than 106,000 young people aged 16 to 24 in Greater Philadelphia who are not in school and not working. Over the past 15 years, the participation of young people in the labor force has declined from 66 percent to 55 percent.

We need to invest in this untapped resource. One organization I want to make sure everyone here knows about is the YouthBuild Philadelphia Charter School. Last fall, I saw firsthand the difference the school is making in helping young people get an education and learn valuable skills, including in the building trades.

The Federal Reserve Banks of Philadelphia, Cleveland, and Atlanta produced a major research study on *opportunity occupations* in the nation's largest metropolitan economies in 2015. Opportunity occupations are jobs that pay at least the national median salary and are accessible to those without a bachelor's degree.

We need to support the growth of opportunity occupations through apprenticeships and mentorship programs that provide training and guidance.

How many people here started working when they were teenagers? Me, too, on a farm near my hometown in New Jersey. I still reflect on things that I learned there and feel grateful for the trust placed in me by John McGroarty, my first boss. I learned about the opportunities that come from working hard and the perseverance it takes to improve when you make a mistake.

Conclusion

I hope that I have paid John's trust and patience forward. One of my primary focuses as president of the Federal Reserve Bank of Philadelphia is on exploring ways to strengthen the Third District in the area of workforce development. We want to hear from you and other employers about how we can be helpful. We have so much potential here.

I have covered a fair bit of ground here, so let me wrap up by summarizing my main points. Overall, my view of the economy is upbeat. Our financial system is in good shape, our economic fundamentals are sound, our labor markets remain dynamic, and our income growth is solid. Consumer spending is also increasing at a solid pace.

We continue to face our challenges head on, and in doing so, we have made significant economic strides as a nation and as a region. The renovation and revival of this beautiful building — where we are today and of other sites on North Broad Street — are illustrative of the resources we have for growth and renewal.

Thank you.