The Outlook for the Economy and Federal Reserve Policy

Philadelphia Business Journal Economic Forecast

Philadelphia, PA (virtual)

January 13, 2022

Patrick T. Harker

President and Chief Executive Officer
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Good morning! It's great to be here. Almost exactly a year ago, I addressed this same group and expressed my hope that the next time we would be together it would be in person. Obviously I'm disappointed that didn't pan out, though I definitely think moving this event to virtual was the right and responsible thing to do as we endure another surge of COVID-19. On the other hand, last year I also lamented the performance of the Eagles — whereas this year, I'm sincerely looking forward to the Birds beating the Bucs this weekend. Win some, lose some, in other words.

Something else I said last year was the standard Fed disclaimer, and that holds true this year as well. The views I express today are my own and do not necessarily reflect those of anyone else on the Federal Open Market Committee or in the Federal Reserve System.

Looking Back

The title of this event is Economic Forecast, and I intend to talk a little bit about where the national and local economies are headed and the path of Federal Reserve policy over the next year. Then, we can move on to our Q&A.

I'm also a firm believer that you can't look ahead without looking back and taking stock of what brought you here. And I've found reviewing my remarks to this group from last year to be a useful exercise.

Begin with the positive: During last year's speech, I noted that about 5 million Americans had been fully vaccinated against COVID-19 — less than 2 percent of our total population. Today, that number stands at about 61 percent. Our region is more heavily vaccinated than the national average: Nearly three-quarters of those in Philadelphia are fully vaccinated against COVID-19.

Widespread immunity has been a boon to public health, and it has also buoyed our economy. While last year I noted persistent unemployment, this year employers are dealing with a very different problem.

There are labor shortages in many industries. That was, to be frank, unexpected — as was last year's inflation surge, which I will discuss in a bit.

So too was the persistence of the pandemic even after mass vaccinations. The euphoria many of us experienced last spring when the vaccine campaign began in earnest has given way to some sense of disappointment as new variants of COVID-19 have emerged and as many millions of Americans have refused to be vaccinated. Particularly troubling is the Omicron variant, which, to some degree, evades the protection afforded by vaccination — though vaccines do continue to largely prevent serious illness.

Looking Ahead: The National Economy

So, where are we headed? Let me begin by noting that, since early 2020, the U.S. economy has largely tracked the path of COVID-19. In spring 2020, we experienced our sharpest contraction on record as policymakers put the U.S. economy into a medically induced coma, shuttering businesses and schools. Since then, we've recovered in fits and starts.

In the early days of the pandemic, I was often asked what "shape" the recovery would take. Would it be a "V?" An "L?" A "U"? More often than not, I liked to say it would look a little bit like a "Nike swoosh" — a sharp decline followed by a gradual upward climb. Today, I'd amend that to say it looks like a Nike swoosh drawn by somebody who has had one too many cups of coffee — i.e., me on many workdays. We're climbing undeniably upward, but it's been a jagged path, largely a result of the virus's wiles. You can see hits to growth that coincided with last year's winter surge, the emergence of the Delta variant last summer, and now Omicron.

What's notable about Omicron is that, by and large, aside from a handful of jurisdictions implementing mask mandates, governments are not imposing public health measures that depress business activity. Instead, we are seeing a diminution in certain categories of consumer spending like restaurant dining, led by consumers seeking to avoid the virus. That's been true throughout the pandemic, of course; many Americans will not engage in normal economic activities if they don't feel safe.

But by virtue of Omicron's extraordinary transmissibility, we are also experiencing something novel during the course of what has already been a novel pandemic: So many people are becoming infected simultaneously that businesses can't staff themselves. Airlines are canceling flights, restaurants are shuttering their kitchens, and big box retail locations are closing down temporarily. Simply put, too many of their workers are sick with COVID-19.

All in all, we're estimating that last year's GDP growth came in a little above 5 percent. I expect growth to be a little slower this year, perhaps in the range of 3 to 4 percent.

The first quarter will be tough, with Omicron continuing to spread throughout the country, shuttering businesses, keeping office workers at home and away from already struggling downtowns, and persuading wary consumers to stay home. Later in the year, even after Omicron has — hopefully — faded, financial conditions should tighten and pandemic stimulus programs will wane, somewhat depressing growth. So I don't expect the kind of gangbusters growth we had in parts of 2020 and 2021 when the economy emerged from pandemic-induced lockdowns.

Looking Ahead: Federal Reserve Policy

When I say financial conditions will "tighten," I am of course referring to how the Fed will react to economic conditions this year. After nearly two years of accommodation, I think we can expect a fair amount of tightening in 2022.

Let's begin by taking a step back and thinking about the Federal Reserve's dual mandate. We are charged by Congress, for one, to maintain stable prices. In practice, that translates to 2 percent inflation. Last year, we exceeded that number significantly. In December, annualized inflation came in at 7 percent, the highest reading in nearly 40 years. Yes, some of this inflation spurt had to do with conditions unique to our pandemic economy — consumer demand was strong, for instance, owing to fiscal relief, but supplies were constrained because of the virus.

But it's clear that inflation is more persistent and higher than any of us want to see. Inflation is effectively a penalty on those with limited means. I'm also concerned that inflation *expectations* could become unanchored.

The second plank of our mandate is to ensure maximum employment. Now, at face value, it may seem that the Fed has so far failed to meet that mandate during this pandemic period. After all, we still have around 3 million fewer people employed than we did in February 2020.

But this is *not* a standard economic downturn; there is plenty of demand in this economy, especially for labor. What the economy is facing is a major supply shortage. It is simply not true — with apologies to reporters in the audience — that the economy created only 199,000 jobs in December, which is how the media reported it. The economy has created many, many millions of jobs over the past year. They just haven't been filled. Look at the unemployment rate, which measures those who are working or who are seeking work. It’s at 3.9 percent right now, and we expect it to fall even further this year. There is no lack of labor demand.

There are many reasons that could explain the depressed labor supply, and I suspect it’s a combination of them that is responsible. Many Americans continue to fear going to work when COVID-19 is widespread; others are having trouble finding someone to take care of their kids at a reasonable price. Millions of others have likely opted to retire, especially with their 401(k)s in such good health. And don’t discount the general reevaluation of life choices that the pandemic has spurred among many of us. Even housing policy is a culprit here. High-cost areas like San Francisco, New York, and Boston will have a hard time attracting new labor supply — and keeping the workers they already have — when housing is so ruinously expensive.

What do all of these explanations have in common? They have *nothing to do with monetary policy*.

The inescapable logical conclusion of this situation — inflation higher than we want and a very robust jobs market — is to tighten monetary policy. I expect us to complete our taper of asset purchases by March. Then, we can probably expect a rate hike of 25 basis points. We could very well continue to raise rates throughout the year as the data evolve.

In other words, this is a very different situation than the one we were in when I joined you last year.

Looking Ahead: The Regional Economy

Now, before we move on to our Q&A, I’d like to talk just a bit about how the local economy is progressing.

All in all, the Philadelphia area’s economy is continuing to make progress toward recovery, particularly in employment. There have been steady gains in payroll employment, unemployment claims have reached new lows, and the unemployment rate has continued to drop. Full recovery, however, is incomplete and vulnerable to ongoing challenges.

The immediate, as I’ve mentioned, is Omicron. Our contacts report the same issues we are seeing nationwide: increasing troubles keeping their doors open as scores of their workers fall sick. It’s been remarkable in our survey work to see how quickly this new variant has spread. In early December 2021, our contacts reported virtually no trouble keeping staff on the job. By the end of the month, the new variant was everywhere, and these reports were widespread across all sectors.

To put this in context, during the week ending January 2, more than 41 percent of Philadelphia MSA businesses surveyed by the census bureau reported a “moderate negative” pandemic effect on business and more than a quarter reported “large negative” effects. Only about 22 percent reported “little or no effect.” That’s apparent in other data; restaurant reservations and visits to retail stores are still well below where they were prior to the pandemic.

Perhaps unsurprisingly, leisure and hospitality remains the sector most affected by the pandemic, with employment down by more than 40,000 in our region. Manufacturing, by contrast, remains relatively robust, with employment largely recovered, recent Omicron challenges notwithstanding. Our region’s manufacturers continue to report troubles accessing supplies, however.

One thing we aren’t lacking is office space, particularly as the pandemic keeps many white-collar workers toiling away at home. Office vacancy rates in Center City are north of 17 percent. Moreover, many tenants are shrinking their office footprints in anticipation of more hybrid work in the years to come.

In Philadelphia, we can expect modest declines in office rents this year, and for lower-quality office space to be converted to other uses, such as multifamily housing. And the continuing dearth of office workers is having knock-on effects to the economy. SEPTA ridership is down by nearly half from before the pandemic. Our central business district has recovered only about 46 percent of the jobs that were lost at the outset of the pandemic.

Housing prices, by contrast, are strong. In the fall, home price growth in Philadelphia County was around 8 percent. Nearby counties in Greater Philadelphia had home price growth ranging between 12 percent and 20 percent.

And, by the way, in case there are any former nurses in the audience, you might want to consider dusting off your RN certification. The most in-demand jobs in our region are for nurses.

Looking Ahead: Football

If there is one thing that this pandemic has taught us, it is the certainty of uncertainty. As always, the Fed — and I’m sure, all of you — will adapt to conditions as they continue to shift under our feet.

So, thank you again for having me, and I’m looking forward to our Q&A. I’m also looking forward to doing this again next year — in person — and celebrating the Eagles’ remarkable 2022 playoff run.