Inflation, Monetary Policy, and the Anchor Economy Initiative

Global Interdependence Center
Philadelphia, PA

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Good morning! It's great to see you all in person, and it's great to be in University City. And, of course, congratulations, George! Your award is very well deserved.

I'd like to take a few minutes this morning to discuss the national economy, inflation, monetary policy, and an exciting new research initiative from the Philadelphia Fed. And then, we can get to your questions. But please, nothing about baseball: The wounds are still too fresh.

Before I can go any further, I need to give you the standard Fed disclaimer: The views I express today 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.

The Economy

Let's begin with the national economy, where there are signs that activity is decelerating. Credit card purchase data indicate that consumer spending, which comprises around 70 percent of economic activity in the United States, is slowing, with services and retail leading the decline. Investment in housing has weakened, and even the boom in manufacturing, which has buoyed the economy, is starting to wane.

After two negative quarters of GDP growth to start the year, the third quarter saw growth of 2.6 percent. That growth was largely due to strong exports. In sum, the reopening boom we experienced as businesses came back to life after a pandemic-induced hibernation appears to be pretty much over.

There is one glaring exception to this rather lackluster data set: employment. The job market continues to run extremely hot. The national unemployment rate is 3.7 percent, and we still have more than 10 million unfilled jobs. All of which is to say, one economic category has certainly not suffered even as other sectors have slowed: Help Wanted signs.

Inflation

Now to inflation, which remains far, far too high.

The Federal Reserve's long-range target is 2 percent annualized inflation, and right now, annualized PCE inflation, including food and energy, stands at 6.2 percent. Prices were up 0.3 percent in September from just a month before. Moreover, inflation is widespread throughout the economy, with numerous categories continuing to register hefty increases.

This is a period of tremendous hardship for Americans, particularly those of low or moderate income. I find it particularly alarming that we're seeing rapid price increases in life's true essentials, like food, rent, health care, and gasoline.

The bottom line is that we can't have a well-functioning economy with high inflation, particularly if high inflation expectations get embedded. To make the economy as efficient as we can in the long run, we have to get on top of inflation.

We are committed to bringing down inflation.

To do so effectively, we need to understand what has caused it. A global pandemic, a war in Europe, and fiscal and monetary policy decisions have combined to limit supply and boost demand. The result has been inflation running at 40-year highs.

Let's begin with constraints on supply.

COVID-19 pandemic lockdowns have badly damaged supply chains. We all know about semiconductor shortages, which have limited supplies of everything from new cars to washing machines. These shortages persist, owing largely to China's Zero-COVID policy. But the pandemic has wrought shortages in more obscure items. A major auto company, for instance, is having a hard time securing enough of its trademark emblems, which has in turn slowed shipments of new vehicles.

Russia's horrific invasion of Ukraine further choked supply.

After Vladimir Putin's forces invaded Ukraine, shipments of grain and fertilizer fell, pushing up food prices. The decline in Russia's energy exports has helped fuel the rise in energy prices, causing an energy crisis in Europe and the U.K. Gasoline prices spiked here, fell a bit, and are now back up again. OPEC Plus has further compounded our problems by announcing it will *cut* production, even in the face of elevated prices. We know that gas prices are incredibly important to consumers and responsible for much of the decline in consumer sentiment.

Certain U.S. government policies have contributed to our supply-side issues. While I remain neutral on the overall wisdom of each of these policies, their effect on supply is undeniable. The federal government applies tariffs on everything from Chinese-made televisions to Canadian lumber. Our immigration policy, such as it is, has resulted in a more than two-year *pause* in legal immigration. As a result, we have about 2½ million fewer workers than we would have had, if we had remained on trend.

All of these supply constraints have been accompanied by robust demand. For one, as I indicated earlier, our labor market remains hot. That means Americans are earning paychecks, even if their relative value is declining because of inflation.

Not surprisingly, low unemployment rates have produced significant upward pressure on wages. In many regions, smaller employers with thin margins are having a hard time filling entry-level positions. We've heard from community bankers who can't compete with larger banks for jobs like tellers.

Fiscal policy has added to demand. The federal government pumped around $6 trillion into American households during the acute phase of the COVID-19 pandemic through programs like mortgage forbearance and student loan forbearance. In fact, the amount of fiscal support provided by the federal government was significantly larger than the aggregate decline in GDP triggered by the pandemic in the first place.

That aid was also dispersed in a largely untargeted fashion. That's understandable, of course: We were in the middle of a full-blown panic, and the federal government needed to get money out the door. But it's clear that policies like these contributed to high levels of demand.

Monetary Policy

And finally, expansive monetary policy — that's us — kept the cost of capital low, which stoked demand.

Throughout most of the COVID-19 pandemic, we kept rates near zero and enacted a major asset-buying program.

As a central bank, the Federal Reserve can do little to affect the supply constraints pushing up inflation. And as I have indicated, those problems, unfortunately, will take time to resolve.

But the Federal Reserve can absolutely affect demand, and that is what we are doing. We want to see inflation coming down steadily and consistently, and we also want to see it abating across a wide array of goods and services. The goal is to adjust conditions so that demand better matches supply.

We have two primary tools for implementing monetary policy: the federal funds rate and our balance sheet.

Since last fall, we have been tightening financial conditions. That process, at least as the market interpreted it, started last September, even before we began to move the federal funds rate or taper our asset purchases. Instead, simply *announcing* that we would soon begin to taper our asset purchases caused two-year Treasury yields to rise.

The taper began in earnest last November and is now complete. In fact, we are now reducing our balance sheet. We are shedding $60 billion in Treasuries and $35 billion of agency debt and mortgage-backed securities each month. Which is to say, we are removing a significant amount of financial accommodation quite rapidly.

We have also raised the federal funds rate 375 basis points since the start of the year. Granted, we started from zero, but we have raised rates significantly — and very quickly.

In the upcoming months, in light of the cumulative tightening we have achieved, I expect we will slow the pace of our rate hikes as we approach a sufficiently restrictive stance. But I want to be clear: A rate hike of 50 basis points would still be significant. Since 1983, the FOMC has increased the target a total of 88 times, and of those, 75 of the hikes were less than 50 basis points.

At some point next year, I expect we will hold at a restrictive rate for a while to let monetary policy do its work. It will take a while for the higher cost of capital to work its way through the economy.

After that, if we have to, we can always tighten further, based on the data. But we should let the system work itself out. And we also need to recognize that this will take time.

Above all, I want to stress that we must remain data dependent and flexible on policy. What we really need to see is a sustained decline in a number of inflation indicators before we let up on tightening monetary policy. And again, we need to make sure inflation expectations don't become unanchored.

So what does all of this mean for the economy? I expect that economic growth will moderate this year as both inflation and tightening financial conditions begin to crimp consumption. Overall, I forecast flat GDP growth for 2022, 1.5 percent growth in 2023, and around 2 percent growth in 2024.

Inflation *will* come down, but it will take some time to get to our target. I expect core PCE inflation to come in around 4.8 percent in 2022, around 3.5 percent next year, and 2.5 percent in 2024.

Turning to the job market, the unemployment rate should peak at 4.5 percent next year as financial conditions bite. It should then fall to 4 percent in 2024, which suggests that, even as we tighten monetary policy, labor markets will stay quite healthy. We've heard from contacts in manufacturing that, given how hard they have worked to staff up, they will be extremely reluctant to cut jobs even as the economy slows.

That gives me confidence that we can bring inflation under control without doing unnecessary damage to the labor market. Our resolve is strong, and our goal of stable prices and maximum employment is achievable.

The Anchor Economy Initiative

Now, in the remaining few minutes, I'd like to describe an exciting new initiative from the Philadelphia Fed called the **Anchor Economy Initiative**. It's fitting that we are convening in University City today because this place exemplifies the Anchor Economy Initiative perfectly.

The Anchor Economy Initiative seeks to quantify the economic impact of higher education institutions and hospitals — *eds and meds* — that we call the *anchor institutions* in their communities.

This is vital work. Anchor institutions are often the largest employers in regions, they're the producers of talent that other businesses need, and they lay the foundation for durable economic growth.

They also have characteristics that other institutions just don't. For one, even though they've made sizable leaps in their use of technology in recent years — especially during the COVID-19 pandemic — higher education institutions and hospitals are physically embedded in their communities. In fact, that's one of the reasons we call them anchor institutions. Unlike corporate headquarters, manufacturing facilities, or sports teams that can pick up and move, higher education institutions and hospitals tend to stay where they are. Hospitals and higher education also tend to be labor intensive, meaning they are often among the largest employers in their regions.

Eds and meds also serve as bulwarks against the vicissitudes of the business cycle. Enrollment in colleges and universities, for instance, is countercyclical, meaning that when the economy slows, usually *more* people go to school, boosting anchor institutions. Hospitals are also recession resistant; after all, people require medical care no matter how the local economy is faring. All of which suggests that regions with strong anchor institutions may have more durable economies than those without.

And in recent years, we've also seen anchor institutions take an increasing interest in building up the areas they serve. They are typically critical partners in community development initiatives. We've seen more hospitals and universities invest in neighborhood economic development, boosting local commercial corridors, seeding residential real estate development, and building neighborhood amenities. Now I suspect you understand the connection to University City.

Anchor institutions' impact goes beyond the immediate. This is a key point that I really want to stress. Fundamentally, anchor institutions stimulate growth through innovation, commercialization, new venture formation, and talent attraction. In that sense, they can drive *long-term* economic development and growth.

We see this here in Philadelphia all the time. The talent and research coming out of our universities and health-care systems have led to the creation of a booming biotechnology industry. Which is to say, anchor institutions are not only often the largest employers *themselves* in regions, they're also the producers of talent that other businesses need.

Let's not sugarcoat things, though. Eds and meds are both being radically disrupted by technology, demographic shifts, and increasing costs. As I alluded to earlier, the COVID-19 pandemic accelerated both telehealth and remote learning. This has certainly created opportunities for health systems and universities to expand their markets, but it also loosened the place-based nature of their services. All of a sudden, these anchors are, frankly, a little less anchored.

Demographics are another downside risk, though with disparate impacts for universities and hospitals. With falling birth rates, fewer 18-year-olds are heading to college and even fewer will enroll in the future, especially if immigration rates remain depressed, as they are now. This demographic shift is most apparent in the Northeast and Midwest, which also happen to have higher concentrations of colleges and universities. That raises real questions about the viability of many of these institutions in the future — and the impact that will have on communities.

On the other hand, an aging population is one that will require more health care, boosting hospitals. Even here, however, the picture is mixed, as many hospitals have closed over the past several years.

Meanwhile, the ever-rising cost of education and health care means that more people may be priced out of accessing eds and meds altogether, which is both a humanitarian concern and an economic one.

That's why, at the Philadelphia Fed, we've developed what we call the **Anchor Economy Dashboard**, a new tool that quantifies the impact of higher education institutions and hospitals on more than 500 regions across the country.

For each of these regions, the dashboard calculates the total number of jobs — direct, indirect, or induced — supported by local eds and meds institutions. Direct jobs comprise those employed directly by anchor institutions, like doctors, nurses, and college professors. Indirect are those working in fields that directly support anchor institutions, like IT contractors supporting a hospital. And induced jobs are those that are supported by the economic activity that anchor economies generate. The folks working at the Last Word Bookshop have induced jobs.

One thing that makes the Anchor Economy Dashboard so neat is that it also calculates a *reliance index* for each region. The reliance index provides a summary measure of how dependent a regional economy is on anchor institutions. It adjusts economic impact by the size of the regional economy and incorporates measures of impact in terms of employment, income, and gross value added. A reliance index of 1 means a region's reliance on anchor institutions is at the national average — below that means it's less reliant, and above that means it's more reliant.

On a national scale, the dashboard clearly shows what I've been talking about: The economic impact of anchor institutions is massive: 9 percent of total U.S. employment, 6.3 percent of total U.S. income, and 8.1 percent of total U.S. gross value added comes from higher education institutions and hospitals. That translates to 18.2 million jobs, $1.1 trillion in income, and $1.7 trillion in gross value added to the economy.

Here in the Philadelphia region, the total economic impact from anchor institutions is more than 495,000 jobs, $33.8 billion in income, and $51.4 billion in gross value added. That's nearly 13 percent of the region's jobs, 8.4 percent of its income, and 11.4 percent of its gross value added. All told, that amounts to a reliance index of 1.39, indicating that our region is more dependent on anchor institutions than the U.S. average.

Conclusion

I urge you all — *after* today's program — to head over to **philadelphiafed.org** to delve into the dashboard. We have data for 524 regions across the U.S. — truly a treasure trove. I think you'll find the information there useful and important.

In closing, I'd like to reiterate my thanks to you for joining us, and the Federal Reserve's strong commitment to bringing down inflation. We will get this job done.

Now, let's get to your questions.