Economic Outlook for Delaware and the Nation

Delaware State Chamber of Commerce
2023 Economic Outlook
Philadelphia, PA (virtual)

October 13, 2023

Patrick T. Harker

President and Chief Executive Officer
Federal Reserve Bank of Philadelphia

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Good morning, everyone.

First, to President Mike Quaranta and the Delaware State Chamber of Commerce, thank you for inviting me for what has become our annual opportunity to be together — even if just virtually.

And, to each of you with us, thanks for allowing me to be part of your Friday.

I know we have a lot of ground to cover and only an hour in which to do it. And as much as I enjoy providing you with my outlook, I much more enjoy the ability to drill deeper into issues through a conversation. So, let's just get right into this.

Of course, I must begin with 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.

Or, as I've become fond of saying, when you're telling your colleagues about this morning's conversation, you can just say, "Pat said," not "the Fed said."

Now, as you can imagine, the two topics I get asked about most are interest rates and inflation. And that makes sense, given the impact they have on the decisions made by both businesses and families. So, I'll start there.

After the last policy rate hike in July, I went on the record with my view that, if economic and financial conditions evolved roughly as I expected, we could hold rates where they are. And while I have been proven wrong in less than two months before, I am happy to say that so far economic and financial conditions are evolving as I expected, if not perhaps even a tad better.

Disinflation *is* under way. Economic activity *has* been resilient. Labor markets *are* coming into better balance. Moreover, these conditions aren't just where I see the national economy but also our regional economy and, specifically for today's discussion, Delaware's. And I'll note those points in turn.

So, I remain today where I first announced myself in early August: Absent a stark turn in what I see in the data and hear from contacts, both in one-on-one conversations and in forums like this, I believe that we are at the point where we can hold rates where they are.

Look, we did a lot, and we did it very fast. 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 — 11 rate hikes in a span of 12 meetings prior to September.

We also turned around our balance sheet policy, and we turned it around fast — and we continue to tighten financial conditions by shrinking the balance sheet.

But the workings of the economy cannot be rushed, and it will take some time for the full impact of the higher rates to be felt. Holding rates steady will let monetary policy do its work. I am sure policy rates are restrictive, and as long they remain so, we will steadily press down on inflation and bring markets into a better balance.

By doing nothing, we are still doing something. And, actually, we are doing quite a lot.

We are also giving ourselves a chance to navigate some of the current uncertainty — labor strikes, oil prices, and the not-fully-exorcised specter of a government shutdown included.

I am more and more confident that not only is monetary policy currently working, but it will continue to work. 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 those 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.

Well, core PCE inflation has also shown clear signs of progress, and the August monthly reading was its smallest month-over-month increase since 2020. So, yes, 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, yesterday's release of September's CPI report came out modestly on the upside, driven by energy and housing. Let me be clear about two things. First, we 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.

Meanwhile, I continue to see GDP growth that is outperforming estimates from earlier this year. This economy is proving to be nothing if not resilient. I do expect GDP gains to continue through the end of 2023, before pulling back slightly in 2024. But even as I foresee the rate of GDP growth moderating, I do not see it contracting. I do not anticipate a recession.

In Delaware, the signals point in the same forward direction. And, in fact, business formation in Delaware, including for high-propensity businesses, remains strong, having risen continually since the pandemic.

Delaware's Coincident Index, the Philadelphia Fed's summary metric of economic activity, increased 3.3 percent year over year according to August data, reflecting generally positive conditions. And, in fact, Delaware's three-month increase of 0.6 percent matched the national rate of increase. In the

Philadelphia Fed's most recent business outlook surveys, which survey manufacturing and nonmanufacturing firms in the Third District, including Delaware, firms overall reported declines in the current month, but their six-month outlooks are optimistic for growth.

Recognizing the importance of tourism to Delaware, I do note that the number of summer overnight tourist stays captured by the Rehoboth Beach–Dewey Beach Chamber of Commerce showed accommodation room counts down from last year's high levels between Memorial Day through Labor Day. However, we know there is probably much influencing these numbers beyond inflation or other economic factors, including the weather.

All this aside, I fully recognize and appreciate these challenges that monetary policy is presenting to you and your businesses.

There are outside factors — factors that bring uncertainty with them — which continue to parallel the more restrictive stance we have pursued through the FOMC. For example, while we are now six months past the spring banking turmoil, the impact of that episode on credit markets is still being felt; this is not new to many of you.

Our contacts throughout the banking sector continue to report tighter credit conditions, which essentially have the impact of higher rates without requiring them to be so.

As I have spoken with contacts throughout the Third District this summer, I have heard from across industry sectors of the challenges presented by both rates and current conditions in access to capital — from banking, to retail, to agriculture and manufacturing, and everyone in between.

I know the impact the current climate is also having in the residential real estate sector, as higher mortgage rates have constricted inventory, which has, in turn, led to increasing prices and a shallowing of the pool of prospective buyers, not just in Delaware but throughout the region and nation.

In consumer finance, which I know is a particularly important sector for Delaware, there is data we follow closely. So, we do take note that while the number of open bankcard accounts is up nearly 6

percent, year over year, the rate of growth in originations is down during that same time span through June, according to the latest available data.

And we do pay attention to the fact that outstanding balances are up more than 15 percent year over year as of August, while more consumers are pushing their payments forward, as evidenced by both the nearly 6 percent increase in the number of outstanding accounts and the increase in delinquency rates.

And in Delaware, the 30-day delinquency rate in mortgages has been trending upward and now exceeds prepandemic levels — 2.4 percent of active loans today versus 2.2 percent in February 2020.

Additionally, the current turmoil in labor markets is likely to similarly exert downward pressure on activity. I would say this is perhaps most notable among the auto worker strike, given the enormous impact of that industry on our overall economy. It's an industry that isn't composed of just the direct manufacturing of cars and trucks but also the business lines of countless downstream component manufacturers and suppliers.

There is also the immediate impact of the strike on consumer spending and economic activity, as striking workers are forgoing their usual wages.

It is obviously too soon to tell the overall impact of this strike, as well as the ongoing labor action in the entertainment industry and elsewhere, on GDP or inflation, but I suspect it will become obvious in the coming months' worth of data.

And while an agreement was reached to temporarily keep the federal government open and running, we don't know what will happen four weeks from now when this agreement expires.

Finally, I also believe this month's restart of student loan payments will have a further dampening effect on consumer spending. How much so, however, remains to be seen.

Turning to the jobs picture, I do anticipate national 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. That is a rate in line with what economists call

the *natural rate* of unemployment, or the theoretical level where labor market conditions support stable inflation of 2 percent.

Now, before you all post "Pat says unemployment is going up" on your social media feeds, 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 where, even as the economy added more jobs, the unemployment rate increased because more workers moved off the sidelines and back into the labor force.

And, beyond the hard data, I also have to balance the soft data. For example, employers throughout the Third District have told me that given how hard it has been to find the workers they currently have, they are doing all they can to keep them.

For Delaware, the jobs picture remains consistent: Three straight months of labor force and household job gains have brought the state's unemployment rate closer to that of the nation than at any point in the prior two years. Jobs numbers in major sectors, including construction, finance, and professional services, are all above where they were in February 2020.

I would also specifically note the nearly 9 percent year-over-year increase in jobs in the leisure and hospitality sector is back to around prepandemic levels.

Surely, the pandemic was such a large health and economic crisis that it marks a "before" and "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. It was a shock, in every sense of the word. To so many, the *new normal* still does not feel *normal.* Again, the pandemic is likely to be a defining event for the generations that experienced it. This is true for families and businesses.

But, having said that, allow me to pose the following final thought: What has fundamentally changed in the economy 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 nationwide and in Delaware, while policy rates peaked below 2.5 percent. From the

cold lens of economics, I do not see the fundamental changes that would call for large changes in natural rates.

But I could also be wrong, and, trust me, that would not be the first time this economy has made me rethink some of the classic models. We just won't know for sure until we have more data to look at over time.

So, it is against this broad backdrop that I believe the prudent position 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. And, my apologies, I simply cannot tell you at this moment. My forecasts are based on what we know as of late 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.

I can tell you three things on my views on future policy. First, I do subscribe to the new moniker, "higher for longer." I didn't coin it, but my expectation is that rates will need to stay high for a while.

Second, the data and what I hear from contacts and outreach, will signal to me when the time comes to adjust policy *either way*. I really do not expect it, but if inflation were to rebound, I know I would have no hesitancy to support further rate increases as our objective to return inflation to target is, simply, not negotiable.

Third, I believe that a resolute, but patient, stance of monetary policy will allow us to achieve the *so landing* that we all wish for our economy.

And I think that is a good place for me to *land* my remarks, so we can get to have a conversation.

Mike, thanks for allowing me the time, and let's start our Q&A.