Outlook for Economic and Banking Conditions

Risk Management Association, Philadelphia Chapter
The National Constitution Center
Philadelphia, PA

October 20, 2023

Patrick T. Harker

President and Chief Executive Officer
Federal Reserve Bank of Philadelphia

The views expressed today are my own and not necessarily those of the Federal Reserve System or the Federal Open Market Committee (FOMC).

Outlook for Economic and Banking Conditions
Risk Management Association, Philadelphia Chapter
The National Constitution Center
Philadelphia, PA

October 20, 2023

Patrick T. Harker
President and Chief Executive Officer
Federal Reserve Bank of Philadelphia

Good morning, everyone.

Thank you to my Philadelphia Fed colleague, Ivy Washington, for that welcome and introduction. I must also acknowledge the efforts of one of my other colleagues from across the street, Robin Myers, for putting this program together.

And I also wish to recognize Senior Vice President and Lending Officer Bill Spaniel, who will be moderating the discussion portion of this morning's program.

I'm also thankful for each of you for taking the time to join us here this morning, especially the morning after a Phillies playoff game.

Now certainly, I can stand up here and speak, but that would only make this a one-way discussion. I want to hear your questions, to engage on the issues that matter to you, and to ensure we make the most of this time. So, allow me to briefly give you my economic outlook and a brief overview of current banking conditions in the Third Federal Reserve District as our launching off point for this discussion.

But before we do anything, I must get the first piece of business out of the way, and that is the usual Federal Reserve disclaimer: The views I express this morning 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.

So, I will begin with the following: I remain rooted in my opinion that we are at the point where holding the policy rate steady is the prudent position to take. I arrived at this decision after carefully reviewing both the hard data and what I've been hearing directly from contacts throughout the Third District.

Further, economic and financial conditions are continuing to evolve as I have been expecting, though I am keeping a close eye on the latest data. There has not been the abrupt shift in data that would lead me to change my current position.

The available data for September have mostly come out stronger than I expected. The latest on retail sales confirms that households retained spending power and did not seem shy to use it over the summer. A resilient consumer is not a problem. Indeed, perhaps the key tenet of a *soft landing* is that households get to adjust their plan for when and how it best serves them — as opposed to the kind of drastic, unavoidable adjustments that come with, say, suddenly losing their job.

Truthfully, the momentum in consumer spending is a bit of a head-scratcher. Contacts talk of a more cautious, price-sensitive consumer. Major surveys also show a steady drop in consumer confidence since the summer. But there could have been some specific factors at play over the summer that we have yet to fully parse out, or we could be right at a turning point, or perhaps the fundamentals are even stronger for households.

Let me stop here to state three things. First, we are not going to tolerate a reacceleration in prices. Second, while I stand ready to revise my views and act accordingly if I see signs of reinflation, I am also not going to overreact to the normal month-to-month variability in data.

And third, we must remain data dependent, and that includes making sure we separate that which could just be noise from that which could be an actual signal. But to make that differentiation — and make it with certainty, as we must — we will need several months of data that we can average.

And this also includes data from the impacts of lingering uncertainties to which we must remain attuned. Prolonged labor strikes, the restart of student loan payments, and international events each come with their own set of economic effects. But we won't necessarily know their extent for some time. We will need to see the data.

The mechanics of the economy cannot be rushed. We raised the policy rate by more than 5 percentage points in the span of a little more than a year. That's a lot of change in not a lot of time. We know that the full impacts of those increases may not yet be fully absorbed across the economy. We also turned around our balance sheet with near equal speed. We put ourselves in restrictive territory very quickly.

But the speed with which we worked then is also part of my argument for holding steady now. As I noted, policy rates are restrictive, and holding them steady now will keep us in restrictive territory and steadily pressing down on inflation. This is a time where doing nothing *is* doing something, and, in fact, I'd argue that it equates to doing quite a lot.

So, allow me to quickly give you my projections based on this stance.

First, on inflation: While headline PCE inflation remains elevated above target, it is almost half of what it was last year on a year-over-year basis. And August's monthly reading was the smallest month-over-month increase since 2020. The data I see, and all that I hear, point to a steady disinflation that is already under way and sustained, if slow. My projections have inflation dropping below 3 percent in 2024 and leveling out at our 2 percent target thereafter.

I expect GDP growth, which has been outperforming estimates from earlier this year, to continue through the end of 2023, before pulling back slightly in 2024. But while I anticipate the rate of GDP growth to moderate, I do not anticipate a contraction. I do not project a recession.

And looking at jobs, I anticipate unemployment to end the year at about 4 percent — just slightly above what the unemployment rate is now — and to increase slowly over the next year to peak at 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, this does *not* mean that I expect mass layoffs. I do not. There are multiple factors that can all influence unemployment rates, including technological changes in the workplace, more workers reentering the labor force, or other public policy choices that may impact workers' decisions regarding their own jobs. And sometimes these forces simultaneously exert their push and pull.

So, when we look at all of this, my view is that we need to exhale, allow the policy actions we've taken to continue to work, and closely watch the data before making any decisions on moving the policy rate in *either* direction. A resolute, but patient, stance on monetary policy will allow us to achieve the soft landing that we all wish for our economy.

Now, as for when I anticipate rates coming back down? That is a question to which I don't yet have an answer. My forecasts are based on what I know as of now. And as time goes by, as adjustments are completed, as new data emerge, and as we gain additional insight on the underlying trends, I may need to adjust my forecasts, and with them, my time frames. Suffice it to say, rates will need to stay high for a while.

Now, let me briefly turn our attention to banking and financial conditions as we currently see them in the Third District. Bill and I will be able to dive more deeply into this area with you during our discussion. But here are the broad strokes.

I'll start by recognizing that, overall, current capital levels remain adequate as institutions across the District continue to have sufficient liquidity. Thankfully, banks throughout the District have not experienced widespread drop-offs in deposits, and deposit levels have been on a return upward toward historical levels. Earnings remain strong, though an increase in interest expense remains a concern.

Business lending has continued, though it was reported to me by contacts that many borrowers have been turning their focus to their "must haves," not their "like to haves." The decrease in mortgage activity has been notable, as has been widely reported — and certainly this is true both here in our region and nationwide. Asset quality throughout lending portfolios has remained favorable.

Thirty-day delinquency rates among all active loans, while trending higher, remain below their historical and prepandemic levels.

However, with all of this comes both interest rate and liquidity risks as deposits return to their prepandemic levels, the funding gap that it is creating, and the balance sheet impacts of the increases in policy rates.

One of the largest concerns to me, at least in the immediate Philadelphia area, remains the commercial real estate (CRE) sector. Office vacancy rates remain above their prepandemic levels, while office net absorption rates remain stubbornly negative. The placement of the Wanamaker Building, arguably one of this city's premier addresses, into receivership looms large.

However, District-wide, it has been reported through contacts that CRE portfolios aren't necessarily facing the same risks as here in Philadelphia. As one contact relayed, the local dentist offices aren't going to remote work. So, overall, CRE lending and loan performance remains sound.

On the operational side, we have continued to urge our contacts to remain vigilant to cyberattacks and to carefully monitor any novel tech-driven activities with which they may become engaged, including in crypto and partnerships with nonbanks to deliver financial services to customers.

But, again, throughout the District, the banking sector remains strong and not broadly impacted by the spring's banking turmoil. Customers can have faith in their deposits and in their financial institutions.

Look, overall, we continue to be in a sound region of the country. Earlier this week, at a prior event, I was asked about our region's economic health. My response was the following: Philadelphia doesn't seem to ride the highs or lows that other regional economies do; we seem to always just keep going.

And that is where I would put us at this moment. Our region continues to move along. We see positive signs for our economy and our collective future.

I think that's good point for me to end. I am sure you have questions, and I am eager to get to them.