Economic Outlook

New Jersey Bankers Annual Leadership Forum
Somerset, NJ

January 20, 2023

Patrick T. Harker

President and Chief Executive Officer
Federal Reserve Bank of Philadelphia

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Good morning! It's great to be here. As a lifelong Jersey boy, I'm very glad to be with a group of my fellow New Jerseyans. Though as a lifelong *South* Jersey boy, I'm not so sure how I feel about doing this way up here in Somerset.

I plan to talk a bit about the country's economic outlook and my approach to monetary policy. Then we can get to questions, which I'm really looking forward to.

But before we do any of that, I need to give you my 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.

How We Got Here

As we begin, I think it's worth taking a step back and considering, briefly, how much has transpired over the past several years. You really can't understand where our economy is, or where it's going, without considering where we've come from.

First and foremost, of course, is the humanitarian tragedy that our country — and our world — has endured because of the COVID-19 virus over the past three years. More than 7.5 million people globally have perished from the virus, including more than 1 million of our fellow Americans and 35,000 New Jerseyans. This is a public health catastrophe on a global scale that is unprecedented in any of our lifetimes.

The tribulations of the U.S. economy over this period have been startling as well. During the early part of the pandemic, the national economy suffered its largest contraction in recorded history as the virus spread and state and local governments shuttered businesses that they deemed nonessential. Tens of

millions of Americans were thrown into joblessness in one of the sharpest recessions in American history.

That downturn was followed by a period of extraordinary economic growth as states loosened restrictions and, with astonishing rapidity, highly effective vaccines against COVID-19 were developed and deployed.

But even as the economy came roaring back to health, scars were visible. Many older Americans had opted to retire at the onset of the pandemic, leaving labor force participation below where it was before COVID-19 arrived on our shores. Supply chains were badly damaged by the virus itself as workers fell ill, and by government lockdowns, which shuttered factories for extended periods. This left crucial items like computer chips in short supply. Meanwhile, large doses of fiscal spending from the federal government and accommodative monetary policy from the Federal Reserve stoked demand. This led to a phenomenon known colloquially as "too much money chasing too few goods" and the highest inflation in four decades.

Where We Are Nationally

High inflation is a scourge, leading to economic inefficiencies and hurting Americans of limited means disproportionately. I find it particularly disturbing that life's true essentials like groceries, fuel, and shelter have skyrocketed in price.

The Federal Reserve is absolutely committed to bringing inflation back to our 2 percent target.

And we're doing that by adjusting our monetary policy. Last year, we raised the target for the federal funds rate to between 4.25 percent and 4.5 percent. That was a significant move, and a very fast one, given that we started the year at about 0 percent. I expect that we will raise rates a few more times this year, though, to my mind, the days of us raising them 75 basis points at a time have surely passed. In my view, hikes of 25 basis points will be appropriate going forward.

At some point this year, I expect that the policy rate will be restrictive enough that we will hold rates in place to let monetary policy do its work. We are also shrinking our balance sheet, which is removing a significant amount of accommodation in and of itself.

Our goal is to slow the economy modestly and to bring demand more in line with supply. The Federal Reserve obviously can't fix problems like supply chain issues, or an endemic shortage of workers, though

it does seem like these problems are finally easing a bit. But we can affect demand by making it more expensive to borrow money. And that's clearly already happening: We're seeing unmistakable signs of a slowdown in the most interest-rate sensitive parts of the economy, like housing.

What's encouraging is that even as we are raising rates, and seeing some signs that inflation is cooling, the national economy remains relatively healthy overall. In parts of 2022, the economy grew modestly even as we were tightening monetary policy substantially. Although inflation is biting, many Americans are still spending — even if they dip into their savings to do so.

We're seeing a healthy recovery in those sectors that suffered the most during the pandemic, like leisure and hospitality, while some sectors that built up healthy order books like manufacturing are cooling somewhat. I do remain concerned about commercial real estate, as the embrace of remote and hybrid work is clearly dampening demand for office space in central business districts and suburban office parks.

I'm most pleased that the labor market remains in excellent shape. Last year, the U.S. economy created 4.5 million jobs, and while we are seeing scattered layoffs in certain segments like tech, there is little evidence of a major downturn in the job market. In fact, a record number of Americans are employed. And indeed, the national unemployment rate is exceptionally low at 3.5 percent.

Where We Are Locally

In New Jersey, conditions look broadly similar. Much like the national economy, this region's economy reflects weakening conditions in business and interest-rate sensitive areas such as housing, but maintains significant strengths, particularly in the labor market. Payroll growth continues to chug along, unemployment claims have stayed low, and the unemployment rate has continued to drop. In fact, in the state of New Jersey, the unemployment rate stands at 3.4 percent — effectively, full employment. As of the third quarter of 2022, wages were up nearly 5 percent year over year in the Philadelphia–Reading–Camden region.

Our state's strengths are vulnerable to ongoing challenges. One obvious weak spot is manufacturing. Responses to the Philadelphia Fed's most recent *Manufacturing Business Outlook Survey*, which partially covers New Jersey, suggested overall declines in the sector in January. The survey's indicators for current general activity and new orders remained negative, and the survey's future indicators suggest tempered expectations for growth over the next six months.

Housing is also weakening considerably, certainly in part due to higher interest rates. Single-family price growth in New Jersey is trending downward and was only around 9.5 percent year over year in November 2022, well down from the double-digit price growth we experienced during the pandemic. According to Zillow, the share of listings with a price cut has increased over the past year and was 22.7 percent in the Philadelphia metropolitan statistical area (MSA) and 14.3 percent in the New York City MSA as of December. In October, meanwhile, the median days on the market for a house for sale in New Jersey was 51 days, compared with less than 30 days in May 2021, showcasing softening conditions.

Where We Are Going

In happier news, we are finally starting to see steady progress bringing inflation down across an array of goods. With monetary policy doing its work, supply chains healing, and excess demand running off, I forecast core inflation to come in at around 3.5 percent this year — well over our 2 percent target, but suggestive of clear movement in the right direction. Core inflation should fall to 2.5 percent in 2024 and then back down to 2 percent in 2025.

GDP growth will be modest, but I'm not forecasting a recession. The labor markets are simply too hot to indicate a significant downturn at this point. I expect real GDP growth of about 1 percent this year before climbing back up to trend growth of about 2 percent in 2024 and 2025.

Lastly, I do think we will see a very slight uptick in unemployment, probably topping out at about 4.5 percent this year, before falling back toward 4 percent over the next two years. It's an underrated advantage that the Federal Reserve is taking on inflation from a position of such labor market strength.

Conclusion

In sum, the Federal Reserve is committed to bringing down inflation and to maintaining the conditions for a healthy labor market. Given that you are bankers, I would also mention something I always keep in mind as a policymaker: When uncertainty abounds, it pays to be cautious. Just as I, as a member of the FOMC, am working to minimize risk, I also urge you all to think about the risks your clients face and to make good decisions to guard against any possible losses.

So again, thanks so much for having me. Now let's get to your questions.