William C Dudley: Economic overview – Queens and the region

Remarks by Mr William C Dudley, President and Chief Executive Officer of the Federal Reserve Bank of New York, to the Queens Chamber of Commerce and Queens Economic Development Corporation, Flushing, New York City, 11 March 2011.

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Good morning. I am pleased to come to Flushing's Main Street to speak to the leaders of your vibrant business community. I thank the Queens Chamber of Commerce and the Queens Economic Development Corporation for their help in organizing today's breakfast and for reaching out to the people in this room and those we will meet later today – the business, community and academic leadership of Queens.

You may have noticed videos playing as you walked into the room. These videos are the winners of a Federal Reserve Bank of New York contest to promote financial literacy among young adults. This year, students from LaGuardia Community College took both first and second-place in the competition. The top winning video ran as a public service announcement at several movie theaters in New York City. All three videos are available on the New York Fed's website and on YouTube.[1] This is an impressive achievement and I applaud the students and LaGuardia Community College.

Although some people may refer to Queens as an "outer borough," I am quite aware that the center of population of New York City is in Maspeth, Queens. Of course, Queens is special not just for its central location, but also for its extraordinary diversity. Queens continues to serve as a land of opportunity for immigrants from all over the world. Roughly 46 percent of Queens' population is foreign born – more than four times the national average and higher than any other county in the country with the exception of Miami-Dade. Sizable communities of immigrants from countries ranging from Columbia to Korea, Ecuador to Egypt, Greece to Guyana, and Italy to India have made Queens their home.

This morning I will talk to you about national and regional economic conditions. As always, what I have to say reflects my own views and not necessarily those of the Federal Open Market Committee (FOMC) or the Federal Reserve System.

Introduction to the New York Fed

By way of introduction, let me start with a synopsis of what the New York Fed is, what we do and what makes my job so interesting.

The New York Fed is part of the Federal Reserve System, America's central bank, and was created by Congress in 1913. With this act, Congress delegated to the Fed System its constitutional authority to manage the supply of money in the nation's economy. Congress designed the central bank to be decentralized, representative of all regions of the country and independent of the political process.

The Fed System is comprised of the Board of Governors in Washington, D.C. – a federal agency currently led by Chairman Ben Bernanke – plus 12 regional Reserve Banks that span the country. For example, the district overseen by the New York Fed includes all of New

[1] See top winning videos of the New York Fed's Financial Awareness Video Competition on YouTube:
Think Twice Before You Swipe
Debt Comedy Jam
Credit Card Arrest

York, the 12 northern counties of New Jersey; Fairfield County, Connecticut; Puerto Rico and the U.S. Virgin Islands.

Each Reserve Bank is distinct, with its own charter and a board of directors drawn from its district, but overseen by the Board of Governors. The law that created the Federal Reserve made the central bank independent so that policymakers could make decisions about monetary policy in the national interest, somewhat insulated from political pressure. However, the Fed is accountable to Congress.

Congress has set an explicit objective for monetary policy: To pursue the highest level of employment consistent with price stability. This objective is often referred to as our "dual mandate," because it combines two goals: high employment, and low and stable inflation. In order to promote these objectives, we also pay close attention to financial stability, because without financial stability, it is very hard to achieve our goals for jobs and inflation.

The FOMC consists of the Board of Governors plus the presidents of each of the 12 district Banks, and it meets in Washington, D.C., eight times per year to deliberate and vote on monetary policy. As the current New York Fed president, I am vice chairman at these meetings and have a permanent vote. At these meetings, the committee members and I each present our current outlook for the economy. For these assessments, we augment input from our research departments with critical information about local economic conditions supplied by our boards of directors, regional advisory councils and conversations with local stakeholders. My visit to Queens today is a part of these regional activities.

One thing that makes my job even more interesting is that New York has some roles unique within the Fed. For example, the New York Fed is the Reserve Bank charged with implementing monetary policy. At the direction of the FOMC, we buy and sell Treasury securities. We are also the eyes and ears of the Fed on Wall Street, and we supervise many of the largest financial institutions in the country. We operate Fedwire® – the conduit for large money transfers between banks. And, we provide banking services to the U.S. Treasury, and central banks and governments from around the world.

Finally, I must mention that the New York Fed's district could be the most diverse in the System: ranging from the urban density of New York City to the forested sparseness of the northern Adirondacks, to the Caribbean islands of Puerto Rico and the Virgin Islands. All in all, there is a lot to keep my colleagues and me quite busy – even in normal times.

U.S. economic outlook

Now, what is the outlook for economic activity, employment and inflation? In particular, what are the areas of vulnerability that we should be most concerned about?

I am pleased to say that the economic outlook has improved considerably in the past six months. Despite this, we are still very far away from achieving our dual mandate of maximum sustainable employment and price stability. Faster progress toward these objectives would be very welcome.

On the activity side, a wide range of indicators show a broadening and strengthening of demand by households and production by firms. For example, on the demand side, families boosted their real consumption at a 4.1 percent annual rate during the fourth quarter. This compares with only a 2.2 percent annual rate during the first three quarters of 2010. Not surprisingly, businesses' orders and production are following suit. And this revival in activity, in turn, has been accompanied by improving consumer and business confidence.

These contributed to a 2.8 percent growth rate in our most comprehensive measure of national output (real gross domestic product or GDP) in the fourth quarter of 2010. I actually suspect that this number may understate the economy's forward momentum. That is because real GDP growth in the quarter was held back by a sharp slowing in the pace of inventory accumulation. In my view, the revival in demand, production and confidence

strongly suggests that we may be much closer to establishing a virtuous circle that will support stronger growth. What I have in mind is a cycle in which rising household and business demand generate more rapid income and employment growth, which in turn bolsters confidence and leads to further increases in spending. The only major missing piece of the puzzle is the absence of strong payroll job growth. We will need to see sustained strong employment growth in order to be certain that this virtuous circle has become firmly established.

With respect to the labor market, last Friday's report helps resolve some conflicting signals. On one hand, the unemployment rate has fallen sharply over the past three months, dropping to 8.9 percent from 9.8 percent two months earlier. On the other hand, payroll employment gains had been very modest and were not consistent with a sustained drop in the unemployment rate.

Last Friday we learned that the economy added 192,000 jobs in February, and estimates of previous job growth were adjusted upward modestly. Particularly encouraging is the growth of manufacturing jobs. Over the past year we have added factory jobs at the fastest pace since the 1990s. This makes me more confident that job growth in January was temporarily depressed by unusually bad winter weather. Other labor market indicators, such as initial claims for unemployment insurance benefits and the employment components of both manufacturing and nonmanufacturing business surveys have also shown improvement recently.

Although there is still uncertainty over the timing and speed of the labor market recovery, I do expect that job growth will increase considerably more rapidly in the coming months. We should welcome this. A substantial pickup is sorely needed. Even if we were to generate growth of 300,000 jobs per month, we would still likely have considerable slack in the labor market at the end of 2012.

So, why is the economy finally showing more signs of life? In my view, the improvement reflects three developments.

First, household and financial institution balance sheets continue to improve. On the household side, the 2008–09 rise in the saving rate appears to have stabilized in the 5 percent to 6 percent range. Meanwhile, the amount of money they need to service their debt (for mortgages, cars, credit cards, etc.) has fallen sharply to levels that prevailed during the mid-1990s. Debt service has been pushed lower by a combination of debt repayment, refinancing at lower interest rates and debt write-offs. Financial institutions have strengthened their balance sheets by retaining earnings and by issuing equity. As a result, some measures of bank credit are beginning to expand again.

Second, monetary policy and fiscal policy have provided support to the recovery. On the monetary policy side, we at the Fed have maintained unusually low levels of short-term interest rates and engaged in large-scale asset purchases. These measures have fostered a sharp improvement in financial market conditions. On the fiscal side (that is, government spending and taxes), the economy has been supported by the shift in policy to help support growth. In particular, the temporary reduction in payroll taxes could have a particularly strong impact on growth during the first part of the year.

Third, growth abroad – especially among emerging market economies – has been strong and this has led to an increase in the demand for U.S.-made goods and services. Over the four quarters of 2010. real exports rose 9.2 percent. After a disappointing performance earlier in the year, U.S. net exports surged in the fourth quarter.

The firming in economic activity, in short, is due both to natural healing and past and present policy support.

In this regard, it is important to emphasize that we at the Federal Reserve have been expecting the economy to strengthen. We provided additional monetary policy stimulus via the asset purchase program to help ensure that the recovery regained momentum. A

stronger recovery with more rapid progress toward our dual mandate objectives is what we have been seeking. This is welcome and not a reason to reverse course.

Yet, we must not be overly optimistic about the growth outlook. The coast is not completely clear – the healing process in the aftermath of the crisis takes time and there are still several areas of vulnerability and weakness. In particular, housing activity remains unusually weak and home prices have begun to soften again in many parts of the country. State and local government finances remain under stress, and this is likely to lead to further spending cuts, tax increases, or job losses in this sector that will offset at least a part of the federal fiscal stimulus. And we cannot rule out the possibility of further shocks from abroad. For example, higher oil prices cut into household purchasing power, and the situation in the Middle East and Africa remains uncertain and dynamic. Also, we cannot ignore the risks stemming from the longer-term fiscal challenges that we face in the United States.

But in the near-term, the most immediate domestic problems may recede rather than become more prevalent. On the housing side, stronger job growth should lead to more household formation. For example, more young people will be able to move out of their parents' homes when they get jobs. This trend should provide more support to housing demand. And anxieties about the large overhang of unsold homes represented by the foreclosure pipeline may overstate the magnitude of the excess supply of housing. Families that have lost their homes through foreclosures are likely to seek new homes as their income permits, even though many may re-enter the housing market as renters rather than buyers. On the state and local side, a rising economy should boost sales and income tax revenue, and help narrow near-term fiscal shortfalls.

We also need to remain watchful for signs that low interest rates could foster a buildup of financial excesses or bubbles that might pose a medium-term risk to both full employment and price stability. Fortunately, current risk spreads on U.S. financial assets are not unduly compressed. This suggests that people are still being relatively cautious about taking on a lot of financial asset risk.

On the inflation side of the ledger, there are some signs that core inflation is now stabilizing after falling for several years. At the Fed, we track core inflation (which excludes the volatile food and energy prices) because experience and research tell us that core inflation provides the best measure of whether overall inflationary pressures are building up or subsiding. Core inflation has proven quite reliable in predicting future total, or "headline" inflation rates. At the moment, both headline and core inflation remain below levels consistent with our dual mandate objectives – which most members of the FOMC consider to be 2 percent or a bit less on the personal consumption expenditures (PCE) measure.

Recent evidence shows that the large amount of slack in the economy has contributed to declining inflation over the past couple of years. I expect this slack to continue to dampen price pressures in the near term. Inflation expectations are well-anchored today and we intend to keep it that way. A sustained rise in medium-term inflation expectations would represent a threat to our price stability mandate and would not be tolerated.

Nevertheless, we always need to be careful about inflation – even in an environment of ample spare capacity. Let me focus on one issue, commodity prices, for a moment. Surely some of the businesses in the audience have faced the challenge of sharply rising oil, food or metal prices in recent months. For example, the spot GSCI – a broad measure of commodity prices – has risen more than 35 percent over the past year. This was in train before the upheavals in the Middle East and Africa raised market concerns about potential disruption to oil supplies, pushing energy prices – though not other commodity prices – still higher. Commodity price pressures are pushing measures of headline inflation above measures of core inflation, which, as I mentioned, exclude food and energy prices. You may have concerns that the rise in commodity prices will turn out to be persistent and, if so, how this might impact the inflation outlook.

From a policymaking standpoint, there are important factors that suggest that it would be unwise for the Federal Reserve to over-react to recent commodity price pressures by raising interest rates soon. Why? First, despite the general uptrend, some of the recent commodity price pressures are likely to be temporary – due to poor weather or geopolitical uncertainties. This is certainly what is anticipated by market participants.

Second, even if commodity price pressures were to prove persistent, they have a smaller impact in the United States than they do in many other countries. Relative to most other major economies, the U.S. inflation rate is lower, the amount of slack much greater and commodities represent a relatively small share of our consumption basket. This small share helps to explain why the "pass-through" of commodity prices into core measures of inflation has been very low in the United States for several decades.

Third, the Federal Reserve's success in anchoring inflation expectations has also been important in limiting pass-through. Since 1984, for example, when the Federal Reserve began to achieve success in driving down and then subsequently anchoring long-term inflation expectations, there has been very little evidence of commodity price pass-through into core inflation. In contrast, prior to 1984, when inflation expectations were much less well-anchored, pass-through did occur and, at times, played an important role in pushing underlying inflation higher.

Thus, while rising commodity prices may be giving some of you a bad headache, they are not likely to lead to a sustained rise in inflation to levels inconsistent with our dual mandate. We will have to ensure, however, that these pressures do not cause inflation expectations to become unanchored. If that were to occur, that would be a troublesome development that would complicate the pursuit of our dual mandate of high employment and low and stable inflation Because we have an Federal Open Market Committee meeting next Tuesday, I will not comment today on the implications of the economic outlook for monetary policy.

Outlook for the region and Queens

Now, let me turn briefly to the situation here in the city and in Queens, in particular. While the national economic outlook improved considerably during the latter part of 2010 and into early this year, growth in New York City's economy appears to have slowed a bit.

The regional economists at the Federal Reserve Bank of New York have developed a composite economic index for New York City. It incorporates measures such as employment, unemployment and income, and can serve as a barometer of the state of the local economy. Based on this measure, the city's economic activity, which had declined fairly sharply throughout much of 2008 and all of 2009, rebounded at an encouraging pace in the first half of 2010. Growth slowed in the second half of the year, but recently released employment data point to some pickup in the city's economy in early 2011 and suggest that the local economic recovery remains on track.

Over the past year, employment in the city has expanded fairly strongly in a number of key industries, including finance, professional and business services, education and health, and tourism, including air transportation. Job losses in construction and government, however, continue to weigh down growth. Meanwhile, New York City's unemployment rate has edged down steadily over the past year, though it remains unacceptably high at 8.9 percent. Unfortunately, as in the rest of the nation, much of the recent drop in the unemployment rate has come from people withdrawing from the labor force so that they are no longer counted as unemployed. Some of the unemployed have been able to find jobs, but not in large numbers thus far.

Where do Queens' residents find employment? While many of them commute to work in other boroughs (primarily Manhattan), Queens has a formidable industrial base of its own. As the home to the city's two major airports, the volume of air traffic coming through Queens ranks third highest among U.S. counties. Not surprisingly, then, transportation is Queens'

largest industrial specialty; it accounts for 12 percent of total employment – four times the national average. Air transportation alone accounts for 6 percent of Queens' jobs, or 15 times the nationwide share. But, of course, Queens has a diverse economy, with jobs in industries ranging from medical care to construction, not to mention printing and a number of other manufacturing industries that benefit from being in a large population center.

During the recent recession, Queens' dynamic economy was hard hit, yet it proved more resilient than Manhattan's and much of the nation's. From peak to trough, employment declined by roughly 3 percent in Queens, far less than the roughly 7 percent plunge nationally and the 4.5 percent loss in New York City as a whole. Although borough-specific economic data are not quite as current as city-wide data, we at the New York Fed see clear indications that employment in Queens stopped declining in the first half of 2010. We hope that upcoming reports will show a sustained upturn. With prospects for the national economy improving in early 2011, the outlook for Queens' diverse and vibrant economy – and New York City's as a whole – seems to be brightening as well.

Conclusion

To sum up, the national economy experienced a pick-up in activity during the last quarter of 2010 that shows signs of continuing in 2011. Although the city's economy saw some loss of momentum, I would not be overly discouraged. After all, soft patches are not uncommon during economic recoveries. Both nationally and regionally, unemployment remains stubbornly high, but many indicators suggest that conditions are in place for stronger growth in the coming months.

Thank you for your kind attention. I would be happy to take a few questions.