William C Dudley: The national and regional economic outlook

Remarks by Mr William C Dudley, President and Chief Executive Officer of the Federal Reserve Bank of New York, before the Bronx Chamber of Commerce at the New York Botanical Garden, Bronx, New York, 24 October 2011.

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Good morning. I am very pleased to be at the New York Botanical Garden to speak to members of the Bronx Chamber of Commerce this morning. The Garden is one of the jewels of the Bronx and it is always a pleasure to speak with the business leaders of a community as vibrant as the Bronx.

Over the past 20 months, I have been engaged in a series of outreach meetings all across my Federal Reserve District. I consider these visits just as important as my trips to Washington, D.C., to help formulate monetary policy or to Switzerland to shape international bank regulation. The understanding that I gain today will help ensure that my policy decisions reflect the public interest in the broadest sense.

Each visit within the region helps me deepen relationships with the people I represent. As you may know, the New York Fed's District includes all of New York State; 12 counties in northern New Jersey; Fairfield County, Connecticut; Puerto Rico; and the U.S. Virgin Islands. This year I have met with community leaders, businesses and elected officials around the region.

Although the Bronx is the city's second smallest borough, it has 1.4 million residents – equal to the combined population of three to four average U.S. cities. You host world-class institutions such as the Yankees, the New York Botanical Garden, the Montefiore Medical Center and the Hunts Point Market. You also are home to the largest Dominican population in the city and sizable groups from around the globe. In sum, the Bronx is a major metropolitan area and economic force all on its own.

What the New York Fed does

By way of introduction, I will briefly review what the New York Fed does and what makes my job so interesting. As always, what I have to say reflects my own views and not necessarily those of the Federal Reserve System or the Federal Open Market Committee, also known as the FOMC.

I serve as Vice-chair of the FOMC – a Federal Reserve committee that meets eight times a year in Washington, D.C., to set interest rates and make other decisions about monetary policy. At FOMC meetings, each Committee member presents a current regional and national outlook. For these assessments, we consult our researchers and add critical information that we learn from our boards of directors, regional councils and community leaders, such as you.

At the New York Fed, we continually track conditions in our District and have created tools for that purpose. For example, my staff produces monthly indexes of economic activity – essentially local measures of output – for the city, New Jersey and New York. We have also started a consumer panel to track local household credit conditions.

In addition, we have a new survey about credit and financing for small businesses. Almost 900 regional businesses responded to our May 2011 poll – nearly 10 percent from the Bronx. If you, as part of a small business, would like to participate in our January poll, please pass your card to my colleagues in the audience.

This December we will host a workshop for the New York City metro area's small businesses – to provide information about credit enhancements and loans from the Small Business

Administration. I will send your president, Mr. Caro, details about how to register. I hope to see you in at the New York Fed in lower Manhattan in December.

As you know, even states as wealthy as New York have large pockets of poverty. So, we target some key initiatives specifically to low- and moderate-income groups. We have worked hard to help neighborhoods, including some in the Bronx, that face high foreclosure rates. Later today, I'll tour some hard-hit areas with the city's commissioner of Housing Preservation and Development.

To share what we learn about our diverse District, we have a rich website. I invite you to visit newyorkfed.org to explore our detailed maps and information on small business, credit and housing conditions.

Finally, and crucially, in the aftermath of the financial crisis, we are working with Fed colleagues and other agencies to help put the nation's financial system on a firmer footing. Yet, much remains to be done and we are determined to keep at it. I recognize fully that there can be no return to pre-crisis business as usual – whether on the part of the financial sector or on the part of regulators like ourselves.

All in all, there is a lot to keep my colleagues busy.

National economic conditions

Now, let me update you on national economic conditions.

Put simply, growth in 2011 has been disappointing. We entered the year with some momentum, spurred by fiscal and monetary policy stimulus. U.S. economic output grew at a 3 percent annual rate from mid-2009 through 2010. While hardly a blistering pace, it was sufficient to reduce the unemployment rate by a half percentage point during 2010. Then, during the first half of 2011, growth slowed so much that the unemployment rate rose back up to 9.1 percent.

Growth slowed partly because of temporary factors. As these factors have subsided, growth has picked up. But the consensus expectation for 2.4 percent annualized growth in the third quarter is still disappointing.

Looking forward, I regard continued modest growth as the most likely outcome. This sluggishness convinces me that other, more persistent factors must also be holding back growth. And, given the depressed level of household and business confidence and the fragility evident in financial markets, I also conclude that there remain significant downside risks.

It is worth elaborating on these points. First, what are the temporary factors that slowed growth in early 2011? Of the items noted by the FOMC, two bear special mention:

- Energy and commodity prices rose sharply over the six-month period ending in May 2011. This sapped households' real purchasing power here and abroad, so they responded by both consuming less and cutting savings.
- April's tragic earthquake in Japan disrupted many global supply chains. Many goods assembled here contain Japanese-made parts. When Japan was unable to produce parts, U.S. production and sales slowed. I am certain that parts shortages affected many sectors here and abroad.

These temporary factors are now waning. Nonetheless, four factors are preventing a more vigorous recovery:

- First, problems in the housing market are a serious impediment to a stronger economic recovery. Residential construction – which typically boosts economic activity during a recovery – is at a standstill. Moreover, many homeowners are now consuming less because the decline in house prices reduced their wealth and they are concerned that the decline in home values and wealth may not be over.

Mortgage rates are at record lows and house prices no longer appear overvalued on affordability measures. But obstacles to refinancing and access to credit for home purchases are limiting the support provided by low rates to house prices and consumption. Meanwhile, the large supply of foreclosed homes for sale – and the prospect that unemployment and negative equity will continue to feed the foreclosure pipeline – continues to put downward pressure on home values. The risk of further house price declines in turn discourages would-be buyers from entering the market.

Continued house price declines could lead to even more defaults, foreclosures and distressed sales, undermining wealth, confidence and spending. Breaking this vicious cycle is one of the most pressing issues facing policymakers.

- Next, cutbacks in employment and spending by state and local governments intensified in 2011 and are likely to continue. Looking forward, states are likely to cut spending further as the federal government stimulus aid to states peters out.
- In addition, by current law, in 2012 the federal government will end much of the support it has been providing to the economy through stimulus programs. As these measures expire, households will be able to consume less and businesses will have less incentive to invest for a while. Plus, the new Budget Control Act calls for additional sharp cuts in federal spending. Our nation needs to get its public finances in order. Done correctly, with a focus on the long term, this could support confidence and growth. But it is very important to avoid excessive short-term cutbacks or tax increases that could harm the recovery.
- Finally, the sovereign debt crisis in Europe has weakened the outlook for global growth and with it, U.S. exports. To date, these effects have been much more acute in Europe than here, but spillovers to the United States may occur, so we need to monitor them carefully.

Thus, our economy continues to face some serious headwinds. Without robust growth, the economy is more vulnerable to negative shocks, which unfortunately seem to keep coming. It is like riding a bicycle – at a slow speed, the bicycle wobbles and the risk of falling rises. Politics have not helped. The intense debate around raising the debt ceiling took a toll on confidence. More recently, the difficulties in Europe and lower U.S. growth prospects made investors less inclined to take risks, spurring a major stock market sell-off and widening credit spreads. All these events increase the downside risks to growth.

Let me turn now to the inflation outlook. As you may know, the FOMC has two charges: promoting stable prices and sustainable growth. This has been a tough year on both counts. Unemployment remains too high. At the same time, inflation has risen more than expected. Nevertheless, because monetary policy works with a lag, we have to make policy based not on where inflation is today, but where it is headed in the future. I believe that underlying fundamentals will help to subdue inflation over the next few quarters.

As of August, the 12-month change for a broad measure of consumer prices was 2.9 percent, almost double the change in the year before. However, the bulk of that increase was due directly to the run-up of energy and commodity prices, which tend to bounce around a lot. Measures of the underlying rate of inflation have moved up too, but by less and to levels broadly consistent with price stability. I expect those to subside soon, as well. It is important to remember that a year ago the worry was that deflation – meaning a persistent, widespread decline in prices – might take hold. Deflation tends to inhibit growth because people and companies have a harder time paying down debt and may defer investments and purchases when prices and wages are falling. Avoiding outright deflation is a very good thing.

Thus, barring more energy price jumps, I expect inflation to fall late this year and next. Moreover – and this is crucial – households' inflation expectations remain well anchored. Low and stable inflation expectations help us to deliver low and stable inflation.

In light of the current weak outlook, the FOMC has announced that we expect to keep short-term interest rates exceptionally low at least through mid-2013 and will change the composition of the assets the Fed holds to provide additional support for growth. In addition, we have discussed the range of policy tools available to promote a stronger economic recovery even as we keep inflation pressures in check.

Just like interest rate cuts in normal times, our monetary policy provides support through lower interest rates that encourage private-sector business investment and household spending. This policy tool should not be confused with fiscal stimulus or government spending.

I believe that the actions we have taken recently will be helpful in supporting growth and jobs. However, I do not think that monetary policy is all-powerful. To get the strongest possible recovery we need reinforcing action in areas such as housing and fiscal policy.

- Stabilizing the housing sector is particularly important because housing equity is an important part of household wealth. This calls for a comprehensive approach to housing policy, starting with an urgent effort to remove the obstacles that make it difficult for all borrowers to refinance at today's low mortgage rates, but extending beyond this to tackle other problems weighing on housing. Taken together, such efforts could help shift people's expectations about future house prices. If prospective homeowners no longer fear that prices could decline further, they will be more willing to enter the market to take advantage of reduced prices and low financing costs, and existing homeowners will feel more confident about spending. A vicious cycle could be replaced by a virtuous circle, in which stabilization in house prices supports spending, growth and jobs. Today, the Federal Housing Finance Agency (FHFA) set out plans to address one element of the problem – obstacles to refinancing for borrowers with high loan-to-value ratios. I welcome this as a step in the right direction and hope that more will follow.
- On the fiscal side, it is important that we see progress in Washington in addressing the long-term fiscal challenges facing the country in a manner that is credible and supports economic recovery. Not only is this important to reassure households and business that the U.S. budget is on a sustainable path, but also this would be important from a larger confidence perspective – demonstrating to our citizens and the world that the political process can still work to make tough choices in the national interest. In this regard, the ability of the so-called Congressional "Super Committee" to reach agreement on a way forward is an important opportunity that I hope is not squandered.

Regional economic conditions

Now, how has the region fared during the downturn and its aftermath? Based on the New York Fed's indexes,[1] the downturn in the economy in New York City ended in November of 2009. Since then, the city's economy has been on the mend and, as of September, the recovery continues at a healthy clip.

The local economy has fared better than the nation during this deep recession and slow recovery. Employment fell by a smaller percentage in the city than it did nationally. During the recovery, New York City has already regained half of the net jobs lost during the recession.

[1] *Regional Indexes of Coincident Economic Indicators*

This has happened without much help from the securities industry (Wall Street), a key driving force behind past local economic recoveries. The strongest job growth has been in professional and business services, leisure and hospitality, and – importantly for the Bronx – education and health services.

Although closely linked to the rest of the city, the borough has its own vibrant economy. Some manufacturing takes place here, particularly in food, apparel and textiles. In addition, Hunts Point may be the world's largest food distribution center. However, the largest sectors – health and education services – account for nearly half of all private jobs in the borough. In education, the Bronx hosts Fordham University and the Albert Einstein College of Medicine, among others. As for health services, numerous facilities include the Montefiore Medical Center, now the borough's largest employer.

I am pleased to report that the Bronx, unlike the nation and the city overall, sustained almost no net job loss during the recession. While national employment remains well below its pre-recession peak, the Bronx has added 10,000 jobs since the recession began. Some of this resilience is due to the borough's concentration in health and education – the only sectors that grew nationally during the recession. Another factor is that Bronx residents largely rent their homes, so they were less vulnerable to the fallout from the housing crisis.

This is not to say that all is well here. Some 12 percent of the Bronx workforce – a painfully high share – is jobless and less than a fifth of its adult population hold a college degree. The seeming disconnect between the pace of job creation here and high unemployment reflects commuting patterns. Many Bronx residents work in Manhattan and other places where job trends have been less favorable. In addition, not all jobs in the Bronx are filled by borough residents.

High unemployment and low average levels of education help explain why the per capita income here is less than two-thirds of the national average. A quarter of the population here lives below the poverty line, more than double the national rate. Reducing poverty and raising the graduation rate are clearly major challenges for policymakers here,[2] even though the Bronx, like the city, seems headed in a promising direction.

How are families here doing in reducing their debt to more sustainable levels? Let me tell you what our special consumer credit panel reveals about the Bronx.[3] Families here, as renters, carry relatively little debt. However, it worries me that in contrast to falling debt levels elsewhere, Bronx residents have not reduced their indebtedness during the last two years.

Also troubling is the 17 percent of household debt in the Bronx that is seriously delinquent: roughly double the rate in the state and nation. Plus, the number of delinquencies is still climbing here, even though they are falling in the state and nation. All of this tells me that Bronx households have a considerable way to go before they reach more comfortable debt levels.

Conclusion

To sum up, over the first half of 2011, the slowing of economic growth in the nation and the weak labor market has been a major disappointment. Recently, growth has picked up modestly, but not enough to reduce unemployment. Despite some bright spots in the U.S. economy, strong headwinds are preventing a more vigorous recovery. Inflation, which has risen in recent months, is poised to slow soon. The Fed is doing – and will continue to do – everything within its power to promote jobs and price stability.

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2 *See, for additional discussion of this topic, William Dudley. 2011. "Job Creation in the Region". Remarks at the Quarterly Regional Economic Press Briefing, New York City. August 12.*

3 *Quarterly Report on Household Debt and Credit, August 2011.*

High poverty, unemployment and delinquency rates suggest that the Bronx faces a number of challenges. However, the continued job growth in the Bronx and rest of the city should create more opportunities for Bronx residents to improve their incomes and personal finances.

Going forward, the key challenge for the Bronx will be to prepare its residents for the best jobs being created in the region. The Bronx must strive to build the human capital – that is, education and skills – of its workforce. A region's human capital determines a large part of its economic success. The Bronx needs to ensure that it can attract and train workers for the broad range of tasks that an advanced economy demands. In addition, expanding education and skills goes a long way to broaden participation in the economy to all residents.

Thank you for your kind attention.