William C Dudley: Impact of the Great Recession on public schools in the region

Remarks by Mr William C Dudley, President and Chief Executive Officer of the Federal Reserve Bank of New York, at the Quarterly Regional Economic Press Briefing, New York City, 27 January 2012.

* * *

Good morning and welcome once again to the New York Fed's Quarterly Regional Economic Press Briefing. I am pleased to have this opportunity to talk with the journalists covering our region – and through you, to the people in our District. This morning I will focus on regional economic conditions, with particular attention to how the recession has affected public school spending in New York and New Jersey – states that dominate the Second Federal Reserve District. Following my remarks, my colleagues will provide more details. 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.

National economic conditions

I will begin with a review of overall economic conditions. Recent data suggest that the U.S. economy ended 2011 on a somewhat stronger note – the best performance since the first half of 2010. Nonetheless, the amount of slack in the economy remains substantial. Moreover, I think it is unlikely that the pace of growth we saw in the fourth quarter will carry through to the first half of 2012.

Growth of consumer spending strengthened in the fourth quarter, adding a needed boost to the economy. Much of this stronger spending was for durable goods, particularly motor vehicles. In the fourth quarter of 2011, sales of light-weight motor vehicles reached the highest quarterly rate since the first half of 2008. This increase is encouraging because it suggests that consumers are now more able to borrow money to finance their purchases of cars and trucks.

However, I must note that this boost is likely due in part to temporary factors. First, vehicle sales in the middle of 2011 were depressed due to supply chain disruptions stemming from the tragic earthquake and tsunami in Japan. In addition, a stimulus-related tax provision that allowed businesses to immediately expense some investments expired at the end of 2011. So, some purchases were no doubt timed to occur before that expiration.

Moreover, for goods and services other than durable goods, the rate of growth of consumer spending has been rather tepid. The picture that emerges – up to now – is of a consumer who continues to be cautious.

In addition to stronger growth of consumer spending, manufacturing output has firmed over the past several months. For example, the widely followed Institute of Supply Management manufacturing composite index rose from October to December 2011. Improvements were particularly notable in new orders and production activity. Stronger growth of consumer spending on durable goods is likely boosting the manufacturing sector. In addition, growth of U.S. exports has been well maintained, while import growth has been subdued.

Alongside the somewhat stronger near-term growth we have also seen some improvement in the labor market. Workers are filing fewer initial claims for unemployment insurance. New claims have fallen to levels not seen since mid-2008. Private-sector employees are working more hours. Aggregate hours worked rose at a 3 percent annual rate in the fourth quarter of 2011, up from essentially no growth in the third quarter. Combined with average hourly earnings rising at a 1.8 percent rate, the increase in hours worked suggests an annual rate of

increase in private wage and salary income of close to 5 percent. This is a respectable rate that might support more spending – if sustained.

A firmer labor market has been accompanied by partial recovery in consumer confidence over the past few months. Confidence is rising up from levels that were often – in the third quarter of 2011 – lower than at the depths of the Great Recession.

It should be noted that while workers' hours grew at a healthy pace in the fourth quarter, employers added an average of just 140,000 payroll jobs per month, somewhat less than in the third quarter. Despite this rather tepid increase in jobs, the unemployment rate fell a cumulative 0.5 percentage points from September to December. This apparent discrepancy is due to two factors – faster job growth as measured by the household survey and an outright decline of the labor force. Workers aged 25 to 54 have been particularly prone to dropping out, which suggests that the decline in the unemployment rate may overstate the improvement in labor market conditions.

Despite some improvements, the economy continues to operate with significant excess slack. Less than 59 percent of the U.S. working-age population has a job. This is unacceptably low – just about the same share as in late 2009 and well below the levels in 2006 and 2007.

Once again, this large amount of slack is putting downward pressure on trend inflation. After a brief run-up during the second quarter of 2011 – reflecting the pass-through from higher commodity prices and supply-chain disruptions – inflation has retreated and may be headed down further.

As I noted earlier, it is unlikely that the faster growth experienced in the fourth quarter of 2011 will be matched in the first half of 2012. In addition to the temporary nature of some of the recent improvement, there are significant impediments to a robust recovery that I'll list briefly.

First, global financial and economic conditions may impede faster growth. In particular, growth in the euro area is slowing and a recession may be underway with adverse direct and indirect effects on the U.S. economy.

Second, fiscal policy has become more contractionary. Despite the extension of the payroll tax cut, the stance of federal fiscal policy has tightened and employment and spending by state and local governments continues to decline.

Third, despite record low mortgage interest rates, the depressed housing market remains a significant impediment.[1] While house prices are no longer overvalued by historical standards, restrictions on access to credit and the large number of homes in the foreclosure pipeline means that home prices remain under downward pressure. The ongoing weakness in housing makes achieving a vigorous economic recovery more difficult for several reasons:

- The strong rebound in housing construction and related activities, such as furniture sales, that typically power economic recoveries following deep recessions is absent.
- The decline in home prices has eroded household wealth, which then inhibits consumer spending. Since home values peaked in 2006, homeowners have lost more than half their home equity and many expect further declines.
- The weakness in home prices has reduced credit availability because many households and small businesses use their homes as their primary source of collateral for loans.

---

[1] See Board of Governors of the Federal Reserve System, 2012 White Paper, ***"The U.S. Housing Market: Current Conditions and Policy Considerations"*** and ***"Housing and the Economic Recovery"*** by William Dudley.

- The big drop in house prices has made it more difficult for borrowers to refinance, undercutting some of monetary policy's ability to support demand.

In a recent speech I discussed some policy interventions that could help to stabilize the housing market. I will not discuss this further as our focus today is on education.

In sum, I continue to expect moderate growth in the year ahead and see the risks to that outlook as skewed to the downside, mainly due to uncertainty as to how events in Europe will unfold.

Earlier this week we had a meeting of the FOMC. The committee reiterated its intention to maintain a highly accommodative stance for monetary policy to support a stronger economic recovery and to help ensure that inflation, over time, is at levels consistent with the dual mandate. The committee said it now anticipates that economic conditions are likely to warrant exceptionally low levels for the federal funds rate at least through late 2014.

The committee also released a statement of longer-run goals and monetary policy strategy within the context of the dual mandate, and published information on individual participants' expectations of the appropriate future interest rate path. As Chairman Bernanke explained in his press conference on Wednesday, the strategy statement "should not be interpreted as indicating any change in how the Federal Reserve conducts monetary policy. Rather, its purpose is to increase the transparency and predictability of policy."

Further details on the discussion at the meeting will be available when the minutes are published in three weeks.

I will not comment on monetary policy any further today beyond stating that monetary policy has done and will continue to do its part in supporting the recovery – but it is not all-powerful. Other complementary policy actions in housing, fiscal policy and structural adjustment or rebalancing of the economy will be essential if we are to achieve the best available recovery.

Regional economic conditions

Turning now to the regional economy, growth slowed in late 2011 in New York City and New York State, whereas New Jersey has seen a modest pickup.

As attendees at previous regional press briefings may recall, the New York Fed produces economic activity indexes to help monitor the performance of the regional economy.[2] Based on these measures, economic activity has leveled off in both New York State and New York City since the summer, following above-average growth in the first half of 2011. In contrast, New Jersey's economy, which was sluggish throughout 2010 and into the first half of 2011, has picked up noticeably in recent months.

We monitor Puerto Rico using an index produced by the Government Development Bank for Puerto Rico. This index suggests that the island's recession, which started back in 2005, may finally be ending. After bottoming out last August, activity has risen fairly sharply – reaching a one-year high in November. Still, Puerto Rico's recovery has had a number of "false starts" before and this measure is noisy. Thus, the recent improvements will need to be sustained for longer before we can confidently declare that the island's recession is over.

Turning to the employment situation, our region finished 2011 on a mixed note. In New Jersey, private-sector job growth was quite robust in the fourth quarter, despite a small dip in December. New York State, in contrast, slowed more in December and has seen only minimal job gains since we last met in August.

---

[2] For more information, see ***Indexes of Coincident Economic Indicators*** on the New York Fed website.

Job growth in the region no longer appears to be out-performing the nation, and regional unemployment rates remain unacceptably high: at around 9 percent in both New York City and New Jersey, and close to 8 percent across New York State.

Turning to New York City, the local job market, which had been quite resilient during and after the recession, has lagged recently – partly reflecting weakness in the city's securities industry. Still, the Big Apple has recovered over half of the jobs lost during the recession, whereas the nation has recouped only about a third of its job losses thus far. Despite recent weakness in the securities industry, other industries, such as tourism, and professional and business services, have fared reasonably well in the City. Weakness in financial activities industry – and securities in particular – is worrisome because this sector has tended to drive overall local growth and provide a major source of tax revenue for the city and the state.

The New York Fed also conducts the Empire State Manufacturing Survey to track conditions for regional manufacturers. I am pleased to say that January's report points to some firming in manufacturing and a pickup in hiring – a big improvement from late last year, when this survey consistently signaled little or no growth.

Nonetheless, ongoing weakness in the housing market, coupled with a sluggish jobs recovery has increased financial pressures on families. Attendees at previous press briefings may recall that at the New York Fed we have a special consumer credit panel that allows us to track these trends closely.[3] Since the beginning of 2008, many regional households have been reducing their per-person debt for mortgages, credit cards and auto loans quite consistently. However, the last three to four quarters show signs that households may have reached the end of this deleveraging process. Debt levels have been flat to slightly increasing in both New York and New Jersey – as they have also been for the United States as a whole. Only in Puerto Rico have debt levels continued to decline, suggesting that households on the island may not be finished with their deleveraging.

The picture for debt delinquencies is similar. Although still quite high by historical standards, as of the third quarter of 2011, delinquencies were subsiding in New York and New Jersey, as they were for the nation as a whole. Unfortunately, Puerto Rican households stand out as now having a higher delinquency rate than the mainland, New York and New Jersey – and one that is continuing to rise. Thus, although the financial strains on many families in the region remain severe and are very troubling to me, they do show some signs of abating slowly outside of Puerto Rico.

Impact of the great recession on public schools in the region

Now, I will turn to our special topic. In an important sense, schools constitute the backbone of our national and regional economy. Yet, this backbone can be vulnerable during recessions. Schools teach our citizens skills, including how to read, write, do math, create art or music and work in teams. Economists call these skills "human capital" because they are an important input that fuels a nation's or region's economic growth and development. In this way, schools play a key role in shaping our future. Therefore, it is essential to understand how the Great Recession has affected our ability to educate the next generations of students.

Thus, today, we will examine how the recession has affected funding levels for schools in our region. As you know, there is an ongoing vigorous debate about how to most effectively organize public education and provide incentives to teachers, students and administrators. Such inquiry is key to any effort to ensure the best possible education for our citizens, but it is beyond the scope of this briefing.

---

[3] For a more information, see ***"An Introduction to the FRBNY Consumer Credit Panel,"*** New York Fed Staff Report No. 479, November 2010. For the recent releases from the panel, see ***U.S. Credit Conditions***.

The housing bust and the onset of the recession in 2007 strained state and local government finances. Most local governments rely heavily on property tax revenue to fund their schools and other activities. This was particularly true during the first half of the decade, when the housing boom strongly supported property tax revenues. Then came the bust; steep declines in the housing market led to corresponding drops in local property tax revenue. State governments' revenues also fell, as rising unemployment cut income tax revenue and reduced consumption shrank sales tax revenues. Since most state and local governments spend at least half of their budgets on education, these developments have constrained funding for our primary and secondary schools.

To stave off drastic state and local government spending cuts, the federal government allocated $100 billion to states, including New York and New Jersey, for education through the American Recovery and Reinvestment Act (ARRA). Research done here at the New York Fed reveals that school finances in both New York and New Jersey were impacted by the Great Recession, with New Jersey sustaining particularly severe cuts.[4] ARRA funds helped school finances in both states, yet did not completely compensate for lost state and local revenues.

With ARRA funding drying up and our local and state economies still under stress, a question looms before us. How might we expect school finances and student learning to fare in the near future? Given the key role that human capital plays in our nation's growth, this is an important issue. We at the New York Fed will continue to monitor school finances and other education indicators in our region closely as this will, over time, affect our regional economy.

Conclusion

In summary, during the second half of 2011, growth slowed in New York, falling well short of the national rate, although New Jersey kept pace. It's also important to note that the national labor market is showing more consistent signs of improvement, and the regional labor market has continued to make progress. However, at the national level, the pace of recovery remains sluggish by historical standards and is likely to slow somewhat in early 2012. Thus, unemployment, both nationally and locally, is likely to remain unacceptably high for some time. Also, inflation is likely to be below our objective for several years. Clearly, much work remains to achieve the Fed's dual mandate of maximum sustainable employment in the context of price stability.

The Great Recession has affected education financing in both New York and New Jersey, but New Jersey was hit harder. Through its impact on the education of the next generation, this situation could have troubling implications for the ability of the next generation to succeed in the demanding jobs of the future.

I will now ask Jason Bram to provide additional details on the regional economy.

---

[4] For more detail, see Chakrabarti, Rajashri and Elizabeth Setren. 2011. ***"The Impact of the Great Recession on School District Finances: Evidence from New York,"*** Federal Reserve Bank of New York Staff Report No. 534; Chakrabarti, Rajashri and Sarah Sutherland. 2012. ***"Precarious Slopes? The Great Recession, Federal Stimulus, and New Jersey Schools,"*** Federal Reserve Bank of New York Staff Report No. 538; and watch for two forthcoming ***Liberty Street Economics Blog*** posts on January 30 and February 1, 2012.