William C Dudley: Job polarization 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, 30 May 2012.

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Good afternoon 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 job polarization, which I would define as the expansion of the number of jobs at the upper and lower ends of the wage and skill distribution and a shrinking of job opportunities for those in the middle. We will see how these trends are playing out in our region. 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

The U.S. economy is continuing to slowly recover from the after-effects of the housing boom and bust and the financial crisis. But the recovery has been disappointing. Indeed, when we look back at economic forecasts made over the past three or four years it is notable that growth has systematically fallen short of both the Federal Reserve and private-sector forecasts.

Despite what has been an unusually accommodative monetary policy by historical standards, the economy has grown at only a 2.1 percent pace over the last four quarters and the Blue Chip consensus forecast only anticipates a modest acceleration to a 2.4 percent rate over the next four quarters.

The headwinds retarding recovery are well known. Consumers have been deleveraging in response to the large losses in wealth generated in large part by the collapse in home prices. Housing activity remains depressed for many reasons. These include the large shadow inventory making its way through the foreclosure pipeline, tight underwriting standards for new mortgage origination, and the sharp slowdown in household formation.

Although the corporate sector as a whole is now reasonably healthy, there still is a significant constraint on the availability of credit to small business. Fiscal policy has become restrictive as state and local governments have cut expenditures in response to revenue shortfalls; and the uncertainty about how Congress and the Administration will address the 2013 federal "fiscal cliff" is likely to inhibit hiring and investment by business. Global economic growth has slowed as European activity has stagnated and this is capping the demand for U.S. exports.

On the brighter side, some of these headwinds appear to be subsiding. Employment growth has picked up somewhat, which should eventually lead to faster household formation and more demand for housing. U.S. banks are healthier so that credit conditions, while still tight, are gradually easing. And, households appear quite far along in the deleveraging process by a number of important measures. For example, the ratio of household debt service relative to income is back to levels last seen in the early 1990s.

For these reasons, I expect that growth will gradually strengthen over the next few years. Nevertheless, significant downside risks remain, especially those related to the challenges in Europe and how the potential "fiscal cliff" in the United States will be resolved after the fall elections. Even if these risks do not materialize, I anticipate only slow progress toward full employment.

On the inflation side, in recent years our forecasts have been noticeably more accurate than on the growth side, and we have succeeded in delivering inflation very close to our 2 percent price stability objective. Through March, as measured by the personal consumption expenditures deflator, overall consumer prices have risen 2.1 percent over the past 12 months, and prices excluding food and energy have risen 2.0 percent.

But price trends have been a bit stickier than one might have anticipated given the large amount of slack in the economy. To some degree, this likely reflects the anchoring exerted by stable inflation expectations. But some of the price pressures can be attributed to other, more temporary, factors:

- Higher oil and gasoline prices and their pass-through into the costs of other goods and services.
- Upward pressure on imputed homeowners rents due to increased demand for rental housing.
- Higher import prices for goods, such as apparel. This reflects many factors including commodity prices pressures and higher wage inflation in countries such as China.

Some of these upward pressures on inflation appear to be fading. Oil and gasoline prices have fallen in recent months. Apparel price inflation should gradually ease, given the sharp drop seen in cotton prices. Owners' equivalent rent should also eventually stabilize as multi-family construction picks up and programs that shift real estate owned by banks to investors so they can be rented gear up.

More generally, there are several reasons to think that inflation will remain moderate and close to our objective. First, and most obviously, the economy continues to operate with significant slack. Second, measures of underlying inflation show little upward pressure. In fact, one – the Federal Reserve Bank of New York's Underlying Inflation Gauge – is turning down. This measure uses a very wide set of variables to forecast the underlying inflation trend. Third, it is hard to be very concerned about inflation risks when the growth rate of nominal labor compensation is so low and stable. It is noteworthy to me that the employment cost index has risen only 2.1 percent over the past four quarters and has shown no acceleration. Fourth, inflation expectations remain well-anchored. This is critically important because inflation expectations are an important driver of actual inflation outcomes. Taking into account the current stance of monetary policy, I anticipate that inflation will decline to slightly below our 2 percent long-run objective over the next few years.

So what does this all imply for monetary policy? I currently anticipate that the Federal Reserve's federal funds rate target will remain exceptionally low – that is at the current level – at least through late 2014.

Given our forecast of stable prices and a still slow path back to full employment, there is an argument for easing further. But, unfortunately, our tools have costs associated with them as well as benefits. Thus, we must weigh these costs against the benefits of further action.

As long as the U.S. economy continues to grow sufficiently fast to cut into the nation's unused economic resources at a meaningful pace, I think the benefits from further action are unlikely to exceed the costs. But if the economy were to slow so that we were no longer making material progress toward full employment, the downside risks to growth were to increase sharply, or if deflation risks were to climb materially, then the benefits of further accommodation would increase in my estimation and this could tilt the balance toward additional easing.

Under such circumstances, further balance sheet action might be called for. We could choose between further extension of the duration of the Federal Reserve's existing Treasury portfolio and another large-scale asset purchase program of Treasuries or agency mortgage-backed securities.

Conversely, I would be willing to consider tightening policy at a somewhat earlier stage if growth strengthened sufficiently to materially improve the medium-term outlook and substantially reduce tail risks, or if there was evidence of a genuine threat to medium-term inflation, including a rise in inflation expectations. In such a case, I would anticipate that the first step would be to bring in the late 2014 date of the policy guidance. This would effectively tighten financial conditions not only by changing the expected path of short-term interest rates, but also by bringing forward the expected start of balance sheet normalization.

Regional economic conditions

Let me turn now to the regional economy, the focus of our presentations today. Since our last briefing, the recovery in the region has picked up some steam.

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. Based on these measures, activity in New York State and New York City has expanded at a healthy clip, while New Jersey's growth continues at a more moderate pace. In Puerto Rico, the activity index produced by the Government Development Bank for Puerto Rico shows that the Island's downturn appears to have ended, but the pick up that we noted at our last briefing has not persisted and the level of activity there has stalled.

Looking at payroll employment, however, the pattern of recovery is a bit more positive, though mixed across the region. New York State and New York City saw faster job growth than the nation since our last briefing. Job creation in the city has been particularly robust and employment in the city is now above its pre-recession peak. In New Jersey, however, employment stands only slightly above where it was at our last briefing and still is well below its previous peak. In Puerto Rico, employment continues to fluctuate near its lows, with no sign of a pickup.

Job polarization

Our special topic today is the issue of job polarization. As I have visited different parts of the district – most recently trips to Long Island, Syracuse and Buffalo – employers have told me that they are beginning to add jobs, particularly in high-tech fields. These jobs can best be characterized as high skilled and technologically advanced. I have heard similar stories from our small business advisory council, our upstate advisory council and even our community banks. These anecdotes are reflected in our research on labor market dynamics. Over the past three decades, job opportunities have become increasingly concentrated in high wage/high skill occupations and low wage/low skill occupations, while job opportunities for those in the middle have been shrinking. At the same time, there has been a growing gap in wages between jobs that pay the most and those that pay the least. Taken together, this phenomenon is often referred to as job polarization.

The root causes of job polarization appear to be technology and globalization, which have displaced many jobs, particularly those involving routine tasks. This loss of jobs has been especially pronounced for what we often think of as traditional middle-skilled workers. Its impact is perhaps most evident in the manufacturing sector, where so many jobs have been lost in recent decades. Given the strong history of manufacturing in our region, job polarization has been an important feature in our local economy.

No doubt, the widening wage gap and loss of job opportunities for middle-skilled workers has contributed to a rise in economic inequality and created challenges for many workers and their families. More than ever before, jobs are requiring a greater degree of knowledge and skill. In order to adapt to these changes, it is increasingly important for workers to acquire and upgrade their skills, whether through formal education or other forms of training. In addition, it is important for employers to communicate their needs to educational institutions so that they can offer the coursework and programs so that people can develop the right skills to fill the available jobs. For these reasons, we think it is particularly important to highlight these trends in today's briefing.

Conclusion

In summary, recent data are consistent with the expectation of moderate growth in 2012 and stronger, but still not robust, growth in 2013. I also expect both headline and core inflation rates should moderate over the next few months. In our region, the recovery of activity and employment has continued, though the data indicate relatively stronger performance in New York State and New York City than in New Jersey, while Puerto Rico has yet to show any meaningful improvement. Our special topic shows a trend toward job polarization both in the nation and the region, which focuses our attention on the ever-growing importance for workers to acquire skills and upgrade their skills on an ongoing basis.

I will now ask Jim Orr to present the update of economic conditions in our region.