William C Dudley: The national and regional economy

Remarks by Mr William C Dudley, President and Chief Executive Officer of the Federal Reserve Bank of New York and Chairman of the Committee on the Global Financial System (CGFS), at the Business Council of Fairfield County, Stamford, Connecticut, 2 July 2013.

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Good afternoon. I am pleased to be here with the Business Council of Fairfield County. I am told that your meetings are very inclusive – that you routinely invite education professionals, executives of local not-for-profit agencies and community leaders as well as business leaders. In doing so, you assemble the type of broad Main Street audience that I most enjoy addressing. So, thank you for inviting me here today.

Today I want to talk a bit about the outlook for the nation and the region. As many of you know, I was scheduled to speak at this forum on October 29 of last year but that meeting had to be postponed because of the arrival of Superstorm Sandy which hit on that very day. The region covered by the New York Fed was at the center of the storm, and Fairfield County, as well as parts of the Connecticut shoreline suffered extensive damage.

Immediately following the storm, our Regional and Community Outreach function worked with all of the affected areas as part of a needs assessment. We asked: “How can the New York Fed best leverage our resources to help our community?” We heard that it could be challenging to find key recovery information and advice online. So we pulled key resources under one roof – or I should say under one URL. We developed our Sandy Information Center with the best information we could find for residents and businesses impacted by Sandy – including key deadlines along with expert legal, finance and insurance guidance.

Conditions are not entirely back to normal, and restoration and repair activities continue in a number of hard-hit neighborhoods. Connecticut, along with New York, New Jersey, Maryland and Rhode Island, have been appropriated federal funding for relief efforts and this should help move the area’s recovery forward. I am confident that these areas will recover over the course of the year. The legislation also contains funding for helping coastal communities to prepare to weather future storms better.

My meeting with you today is part of our continuing efforts to understand what is going on at the grassroots level of our economy. Let me offer a few examples from this trip. Yesterday evening I met with some of Stamford’s business leaders to discuss the local state of economic and business conditions. This morning I met with Mayor Finch and key economic development staff to discuss Bridgeport’s redevelopment initiatives. Local efforts such as these and your business council are essential complements to the Fed’s support for economic recovery. I applaud the efforts of state and local governments and community leaders to bolster the recovery in Bridgeport, Stamford and elsewhere in the district.

I also met with Joan Carty from the Connecticut Housing Development Fund. We discussed innovative approaches for addressing the foreclosure crisis here and across the state. Housing has been a major impediment to a more rapid economic recovery and we at the Fed have been working hard to help homeowners and the overall housing market recover. Afterwards, I spoke with small business leaders about the opportunities and challenges they are facing today. I traveled to Sikorsky Aircraft Corporation with several goals in mind. I wanted to learn how sequestration was affecting ground-level operations, to understand the local and regional economic impact of Sikorsky, and to view state-of-the-art manufacturing at work.

After this program, I will be meeting with Joseph Carbone of The Workplace to discuss best practices and emerging approaches to workforce development, particularly his innovative program for the long-term unemployed which I understand he is piloting in five different cities across the nation. At the end of the day I will be meeting with University of Connecticut (UConn) Stamford campus staff, your own executive director Chris Bruhl and other officials to learn about the ecosystem that is being created to spur further economic development locally. I'll end the day with a meeting with Governor Malloy to better understand the complex issues and opportunities facing the state.

The agenda for these visits is always packed, but that's part of the point – to meet with a diverse array of representatives in order to get a comprehensive picture of what's happening on Main Street and its interaction with state and national developments. At the end of my talk I will be happy to answer any questions you have about the economic outlook from my perspective.

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.

National economic conditions

I would like to begin by taking stock of where we are at the moment. Then I will address my expectations for the performance of the economy over the remainder of 2013 and into 2014.

Since the end of the Great Recession in mid-2009, we have had 15 consecutive quarters of positive growth of real GDP. However, the average annual growth rate over that period has been just 2.1 percent. Although the unemployment rate has declined by 2.5 percentage points from its peak of 10 percent in October of 2009, much of this decline is due to the fact that the labor force participation rate has fallen by 1.5 percentage points over this period. Recall that discouraged workers who do not actively look for work are regarded as not participating in the labor force and so are not counted as unemployed even though they are without jobs. Using an alternative measure, the employment to population ratio, which is not influenced by changes in the number of discouraged workers, there has been limited improvement in labor market conditions. Job loss rates have fallen, but hiring rates remain depressed at low levels. Taken together, the labor market still cannot be regarded as healthy. Numerous indicators, including the behavior of labor compensation and household assessments of labor market conditions, are all consistent with the view that there remains a great deal of slack in the economy.

That being said, I see persuasive evidence of improved underlying fundamentals for much of the private sector of the U.S. economy. Key measures of household leverage have declined and are now at the lowest levels they have been in well over a decade. Household net worth, expressed as a percent of disposable income, has increased back to its average of the previous decade, reflecting rising equity and home prices and declining liabilities. Banks are beginning to ease credit standards somewhat after a prolonged period of tightness. As a result, we are now experiencing a fairly typical cyclical recovery of consumer spending on durable goods. For example, light-weight motor vehicles sold at a seasonally-adjusted annual rate of 15.3 million in May, not far from the 16.1 million sales in 2007.

Similarly, after five years in which housing production was well below what is consistent with underlying demographic trends, it now appears that we have worked off the excess supply of housing built up during the boom years of the last decade. Housing starts and sales are now on a clear upward trend, and a widely followed national home price index is up around 12 percent over the twelve months ending in April.[1] Indeed, anecdotal reports suggest that this higher-than-expected increase in home prices is due to a lack of homes for sale.

Unfortunately, the improvements in consumer spending on durable goods and housing are not yet showing through in the overall GDP growth rate due to the significant headwinds that we continue to face. First, federal fiscal policy has recently become quite contractionary. Estimates from the Congressional Budget Office (CBO) indicate that this fiscal restraint is on the order of 1.75 percentage points of potential GDP this year. In the period since 1960, there have been only two previous episodes of fiscal contraction of this order of magnitude

– 1969 and 1987 – both of which occurred when the economy was on a more solid footing than it is today. Second, the euro area is experiencing a protracted recession and growth in many of the largest emerging economies has slowed. This has resulted in a very sharp slowing of U.S. exports, with an associated slowing in production and employment growth in the U.S. manufacturing sector.

Thus, I continue to see the economy as being in a tug-of-war between fiscal drag and underlying fundamental improvement, with a great deal of uncertainty over which force will prevail in the near-term. This tug-of-war is clearly seen in the monthly employment data. Over April and May, the average monthly gain in employment in the private service-providing sector has been well maintained at 175,000. In contrast, employment in the manufacturing sector and the federal government declined a combined 20,000 per month. And the resulting uncertainty is, I believe, an important contributing factor behind the relatively sluggish pace of business investment spending.

My best guess is that growth for all of 2013, measured on a Q4/Q4 basis, will be about what it has been since the end of the recession. But I believe a strong case can be made that the pace of growth will pick up notably in 2014. The private sector of the economy should continue to heal, while the amount of fiscal drag will begin to subside. I also see some indications that growth prospects among our major trading partners have begun to improve; for example, the rise in the June euro area composite Purchasing Managers' Index. And this combination of events is likely to create an environment in which business investment spending will gather strength.

Finally, I believe this tug-of-war analogy is useful in explaining the recent inflation dynamics. As is well known, total inflation, as measured by the personal consumption expenditures (PCE) deflator, has slowed sharply over the past year and is now running below the FOMC's expressed goal of 2 percent. Softness in energy prices, resulting from the weakening of global growth mentioned earlier combined with increased energy production here in the U.S. has contributed to the slowing of total inflation. However, it is also the case that core inflation, that is, excluding food and energy, has slowed sharply as well. A decomposition of core inflation reveals that some of the decline is due to slowing in the rate of increase in prices of non-food and non-energy goods. This probably is due in large part to the softening of global demand for goods and the modest appreciation of the dollar that has occurred since mid-2011.

In the service sector, the rate of increase in prices of medical services and "non-market" services – the latter includes some financial services – also has slowed notably recently. In contrast, the rate of increase in prices for other non-energy services has been relatively stable. Comparing this set of conditions to that in 2010, the recent slowing of inflation has been less widespread across core goods and core services, and inflation expectations so far have declined less appreciably than they did in 2010. Thus, my best guess is that core goods prices will begin to firm in the months ahead as global demand begins to strengthen and inventories get into better alignment with sales.

As is always the case, there is substantial uncertainty surrounding this forecast. Moreover, there is always the possibility of some unforeseen shock. Thus, we will be monitoring U.S. and global economic conditions very carefully and will adjust our views on the likely path for growth, inflation and the unemployment rate accordingly in response to new information.

At its recent meeting, the FOMC decided to continue its accommodative policy stance. It reaffirmed its expectation that the current low range for the federal funds rate target will be appropriate at least as long as the unemployment rate remains above 6.5 percent, so long as inflation and inflation expectations remain well-behaved. It is important to remember that these conditions are thresholds, not triggers. The FOMC also maintained its purchases of $40 billion per month in agency MBS and $45 billion per month in Treasury securities, with a stated goal of promoting a substantial improvement in the labor market outlook in a context of price stability.

In its statement, the FOMC said that it may vary the pace of purchases as economic conditions evolve. As Chairman Bernanke stated in his press conference following the FOMC meeting, if the economic data over the next year turn out to be broadly consistent with the outlooks that the FOMC sees as most likely, which are roughly similar to the outlook I have already laid out, the FOMC anticipates that it would be appropriate to begin to moderate the pace of purchases later this year. Under such a scenario, subsequent reductions might occur in measured steps through the first half of next year, and an end to purchases around mid-2014. Under this scenario, at the time that asset purchases came to an end, the unemployment rate likely would be near 7 percent and the economy's momentum strengthening, supporting further robust job gains in the future.

As I noted last week in our regional press briefing, a few points deserve emphasis. First, the FOMC's policy depends on the progress we make towards our objectives. This means that the policy – including the pace of asset purchases – depends on the outlook rather than the calendar. The scenario I outlined above is only that – one possible outcome. Economic circumstances could diverge significantly from the FOMC's expectations. If labor market conditions and the economy's growth momentum were to be less favorable than in the FOMC's outlook – and this is what has happened in recent years – I would expect that the asset purchases would continue at a higher pace for longer.

Second, even if this scenario were to occur and the pace of purchases were reduced, it would still be the case that as long as the FOMC continues its asset purchases it is adding monetary policy accommodation, not tightening monetary policy. As the FOMC adds to its stock of securities, this should continue to put downward pressure on longer-term interest rates, making monetary policy more accommodative.

Third, the Federal Reserve is likely to keep most of these assets on its balance sheet for a long time. As Chairman Bernanke noted in his most recent press conference, a strong majority of FOMC participants no longer favor selling agency MBS securities during the monetary policy normalization process. This implies a bigger balance sheet for longer, which provides additional accommodation today and continuing support for mortgage markets going forward.

Fourth, even under this scenario, a rise in short-term rates is very likely to be a long way off. Not only will it likely take considerable time to reach the FOMC's 6.5 percent unemployment rate threshold, but also the FOMC could wait considerably longer before raising short-term rates. The fact that inflation is coming in well below the FOMC's 2 percent objective is relevant here. Most FOMC participants currently do not expect short-term rates to begin to rise until 2015.

To reiterate what I said last week, some commentators have interpreted the recent shift in the market-implied path of short-term interest rates as indicating that market participants now expect the first increases in the federal funds rate target to come much earlier than previously thought. Setting aside whether this is the correct interpretation of recent price moves, let me emphasize that such an expectation would be quite out of sync with both FOMC statements and the expectations of most FOMC participants.

Regional economic conditions

Turning to the regional economy, my colleagues and I at the New York Fed continually track conditions in our District, and we have a number of tools we use for that purpose.

To promote growth in our local communities, we publish extensive data and analysis on the local economy. We provide outreach initiatives, such as our workshops on access to global markets to help small businesses learn about loan programs and sources of credit enhancements. We also run an annual video festival for college students in the Second District. In this program student teams produce videos aimed to help young adults make sound personal financial decisions. A panel of advertising and video professionals selects winning video productions for screening in local movie theaters.

As you know, even states as wealthy as Connecticut have large pockets of poverty. So, we target some of our work specifically to low- and moderate-income groups.

We have worked hard to help neighborhoods that face high foreclosure rates. This work is important obviously because foreclosures are a terrible event for those who lose their homes. But beyond that, this work is important because high levels of foreclosures affect neighbors' home values, the local tax base and economic vitality more broadly. We have provided housing counselors and community groups with the latest information on mortgage conditions via mortgage briefs, roundtables, presentations and an interactive web tool that shows very local monthly delinquency and foreclosure conditions. This past fall we hosted a conference on distressed residential real estate to share new expert analysis with senior policymakers and practitioners from across the nation. Your new Commissioner of Housing – whom I note, formerly worked at the New York Fed – attended that conference.

We also conduct a periodic poll about the credit needs of small businesses, which are an important source of new jobs in the District. If you represent a small business and would like to participate in our next poll, please pass your business card to my colleagues, who are in the audience, or see me after the speech. And if your business is somewhat larger, I urge you to consider becoming one of our business contacts – just indicate your interest to us on your business card.

So how is the region doing? I want to begin by pointing out that Fairfield County has a number of strengths, beginning with a highly-educated workforce: Two in five adults in the county hold a college degree, nearly twice the nationwide average. It also has an array of fine educational institutions, including Fairfield University, UConn Stamford, the University of Bridgeport, Sacred Heart University, Western Connecticut State University, Housatonic Community College and Norwalk Community College.

The industry mix here is quite diverse, with a good representation of jobs in the high-paying finance sector. In fact, roughly 35,000 jobs in the county, about 9 percent of total employment, are in the finance and insurance industry, a share almost twice as large as in the nation and even slightly higher than in New York City. Although the sector has shed jobs over the past two years, it remains an important and valuable component of the local economy. There are also numerous corporate headquarters in the county and a notable manufacturing presence, particularly in the pharmaceuticals, electrical equipment and aerospace industries.

In addition, the whole tri-state region has benefited from its proximity to New York City, where the rebound in the economy – and also in employment – has been much stronger. Fairfield County's connection to New York City is not quite as strong as Long Island's or the lower Hudson Valley: About 7 percent of working residents in the county commute to New York City compared to about 20 percent in those areas. Still, the city's strong pace of job creation during the current recovery is supporting incomes in the county.

Turning to the recent performance of the economy, this area is growing pretty much in line with the nation, at least in terms of employment. That's a bit of an improvement from 2012 when, after solid gains in 2010 and 2011, job creation in both Fairfield County and Connecticut had stalled. Some sectors, such as education, health, and professional and business services were adding jobs; but those were offset by job losses not only in finance, but also in the goods-producing and distributing sectors.

And at the end of October, Superstorm Sandy hit the region, causing major damage and disruption. While most of the news focused on New York City, Long Island and New Jersey, parts of Fairfield and New Haven counties – cities and towns like Bridgeport, Stamford, Milford, and Fairfield – were severely affected as well. Thankfully, Sandy's disruptive effect on the region's economy seems to have been short-lived. Fairfield County did see some job losses during the winter months, and Sandy likely contributed to that. But, in the spring this area saw a strong and broad-based rebound in employment. In fact, in May employment in Fairfield County surged to a more than four-year high.

Even with this recent surge in employment, however, the county has recouped only about 60 percent of the 36,000 jobs lost during the last downturn, whereas the nation has recouped close to three-quarters of its job losses and New York City has more than fully rebounded. And, at more than 7 percent, the county's unemployment rate remains high.

Another dimension of the local economy where we have seen modest improvement is housing. Homebuilding, as measured by housing permits issued, languished from 2008 through 2011; but last year, multi-family construction picked up noticeably, and this year single-family construction has begun to move up as well. Home values have also begun to recover. After falling about 25 percent between 2006 and early 2012, home prices have risen by 5 percent in Fairfield County and 3 percent across Connecticut overall. While this upturn in home prices is encouraging, it has been considerably weaker than in other parts of our region and also weaker than nationally.

The New York Fed's measures of regional credit conditions suggest continued financial challenges for families here. As of the first quarter of 2013, average debt per person was about $60,000 in Connecticut and over $90,000 in Fairfield County – little changed over several years. The county's delinquency rate on that debt is now 5.7 percent, similar to the national average. And the mortgage crisis continues to take a toll on local homeowners. As of the first quarter, about 6 percent of mortgage debt in Fairfield County was 90-plus days delinquent, slightly higher than the national delinquency rate.

It is also important to recognize the county's strengths that will support recovery and the rise in household income over the longer term – over and above just being close to a thriving New York City. In particular, the above-average educational attainment of residents and the numerous educational institutions position the area well to move into the expanding knowledge-based economy. Also, its diverse industry mix has a good representation of jobs in high-paying sectors and the area maintains its attractiveness as a location for corporate headquarters.

Thank you for your kind attention and I will now be happy to take a few questions.