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, at the Whitman School of Management at Syracuse University, Syracuse, New York, 27 September 2013.

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Good afternoon. I am pleased to be here today at Syracuse University. It is always a pleasure to speak with the different communities that make up our region, and it is especially gratifying to have the opportunity to speak with you, our future leaders. So thank you for inviting me.

My meeting with you today is part of our continuing efforts to understand what is going on at the grassroots level of our economy. Earlier on this trip, I met with government and business leaders in Buffalo, Rochester and Syracuse to learn about some of the challenges the region faces as well as the collaborative efforts being taken to further economic development. 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 economic conditions in the region and a fuller understanding of the major issues and concerns. This is our fourth trip to Upstate New York in the past few years and recent trips have also taken us to Northern New Jersey, the boroughs of New York City, Long Island, and Fairfield County, Connecticut.

My outreach trips complement the ongoing efforts of the New York Fed to assess conditions in the upstate New York economy and throughout our District. We monitor economic performance on a monthly basis through our indexes of economic activity and our survey of New York State manufacturers. We also get important input on economic conditions from meetings with our Upstate Advisory Board, whose members are major leaders in the upstate economy. We have constructed a consumer credit panel that allows us to better understand the financial condition of homeowners and students, and conduct a bi-annual poll of small businesses to understand their credit needs and availability. The results of the latter have helped inform a series of clinics that we have conducted to help small businesses take the next step to access capital and identify new sources of funding.

As I mentioned earlier, we are always eager to engage with students, and our commitment to our region includes a series of educational programs worth highlighting. First, *Math x Economics*, which encourages students attending Title 1 schools to consider preparing for a career in finance or economics. And, second, our yearly *Fed Challenge* competitions, in which teams of students from high schools and colleges in the District take on the roles of the members of the Federal Open Market Committee (FOMC) and debate what is the appropriate next step for U.S. monetary policy.

All in all, there is a lot to keep myself and my colleagues fully engaged with the communities we represent.

Next, I'll review recent developments in the national and regional economy, and at the end of my talk will be happy to answer any questions you have about the economic outlook.

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.

National economic conditions

Let me 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.

According to the National Bureau of Economic Research, which determines the timing of economic recessions and expansions, the current expansion began in mid-2009, more than four years ago. However, the expansion has been subdued so far, as the average annual growth rate of real GDP has been just 2.2 percent over the past four years. While that growth

rate is near most FOMC participants' estimates of the U.S. economy's longer-run growth rate as well as those of many outside analysts, a more rapid pace of growth likely is necessary to reduce meaningfully the significant economic slack that developed during the Great Recession.

Consistent with the modest pace of economic growth, improvement in labor market conditions has been slow. Even though the unemployment rate has declined by 2.7 percentage points from its peak of 10 percent in October of 2009, there are still many people that want jobs but are not counted as unemployed because they are not actively looking for work. An alternative measure of labor market conditions, the employment to population ratio, which is not influenced by changes in the number of these workers, has shown limited improvement. 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, are all consistent with the view that there remains a great deal of slack in labor markets.

Nevertheless, as I have stated in earlier speeches, I see persuasive evidence of improving underlying fundamentals for much of the private sector of the U.S. economy. Key measures of household leverage have declined and are now near 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 debt. Banks have eased credit standards somewhat recently 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 nearly 16.1 million in August, close to the number sold 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. Existing home sales remain on an upward trend, and a widely followed national home price index is up around 12 percent over the 12 months ending in July.[1] Indeed, anecdotal reports suggest that this higher-than-expected increase in home prices is due to a lack of homes for sale.

However, a number of risks to the outlook are evident. Long-term interest rates, including mortgage rates, have risen significantly since early May. Since then, we have seen a sharp drop in refinancing mortgage applications, a more moderate but significant decline in purchase mortgage applications and fairly flat housing starts and new home sales. Although I do not anticipate that the rise in long-term rates will lead to a downturn in housing, these developments do suggest that higher mortgage rates have cut into the upward momentum of the housing sector. We will need to monitor upcoming data closely to assess more fully the impact of higher rates on the housing recovery.

Another risk is that federal fiscal policy could exert further restraint on the economy during the rest of this year and in 2014. It is difficult to assess how much of the contractionary effects from sequestration, for example, have already occurred, or still remain ahead. A related issue is the high degree of uncertainty about fiscal policy. In coming weeks, Congress will be considering how to fund the government for the next fiscal year and will also be debating what to do about the debt limit. This creates uncertainty about the fiscal outlook and may exert a restraining influence on household and business spending.

One other risk to highlight is the global economic outlook. Even though the euro area appears to have begun to grow again after a protracted recession, growth in that area is still expected to be fairly weak at best. In addition, growth in many of the largest emerging economies has slowed, and some of the countries with large trade and current account

[1] Based on the CoreLogic home price index including distressed sales.

imbalances have seen their financial markets and currencies come under pressure. If growth abroad were to slow, this could impede the growth of U.S. exports and this could result in less strength in manufacturing production and employment in the U.S.

Thus, returning to an analogy I have used in previous speeches, I see the economy in a tug-of-war between these headwinds and underlying fundamental improvement, with a great deal of uncertainty over when the improvement in the underlying fundamentals will prevail.

In the end, my best guess is that growth for all of 2013, measured on a Q4/Q4 basis, will be near the post-recession average. But I believe a good case can be made that the pace of growth will pick up some in 2014. The private sector of the economy should continue to heal, while the amount of fiscal drag should subside. I also expect that, despite the near-term concerns, growth prospects among our major trading partners will improve next year. And this combination of events is likely to create an environment in which business investment spending will strengthen. However, the notion that the economy will grow more swiftly remains a forecast rather than a reality at this point.

Turning to the inflation outlook, total inflation, as measured by the personal consumption expenditures (PCE) deflator, has fluctuated recently with short-term movements in energy prices, but it continues to run below the FOMC's expressed goal of 2 percent. Core inflation, that is, excluding food and energy, slowed in late 2012 and early 2013 to well below 2 percent, although it has shown signs of stabilizing in the last couple of months.

A decomposition of core inflation reveals that the most recent slowing of inflation has been largely confined to core goods, whereas the rate of increase of core services has been relatively steady. Such was not the case in 2010 – the previous instance of a significant slowing of inflation. In addition, inflation expectations so far have remained relatively stable at levels somewhat above the current inflation rate. This should help prevent an undesirable further drop in inflation relative to our 2 percent objective. Thus, I anticipate that inflation will firm further in the months ahead and move toward the FOMC's longer-run objective. Still, the FOMC recognizes that inflation persistently below 2 percent could pose risks to economic performance.

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.

So what does this all portend for monetary policy? As you are aware, at last week's meeting of the Federal Open Market Committee we made no changes to our monetary policy. In particular, the Committee decided to continue purchasing long-term Treasury securities and agency mortgage-backed securities at a monthly pace of $45 billion and $40 billion, respectively. The FOMC statement reaffirmed the Committee's intention to "continue its purchases of Treasury and agency mortgage-backed securities, and employ its other policy tools as appropriate, until the outlook for the labor market has improved substantially in a context of price stability."[2]

We also reaffirmed our forward guidance with respect to the federal funds rate. The statement notes that the Committee "decided to keep the target range for the federal funds rate at 0 to ¼ percent and currently anticipates that this exceptionally low range for the federal funds rate will be appropriate at least as long as the unemployment rate remains above 6–1/2 percent, inflation between one and two years ahead is projected to be no more than a half percentage point above the Committee's 2 percent longer-run goal, and longer-term inflation expectations continue to be well anchored."[3]

[2] ***Federal Open Market Committee statement***, September 18, 2013.

[3] ***Federal Open Market Committee statement***, September 18, 2013.

One noteworthy question that emerged following the meeting was why the Committee did not begin to reduce the pace of asset purchases. Although I can't speak for the Committee, I can provide some reasons for my own decision.

To begin to taper, I have two tests that must be passed: (1) evidence that the labor market has shown improvement, and (2) information about the economy's forward momentum that makes me confident that labor market improvement will continue in the future. So far, I think we have made progress with respect to these metrics, but have not yet achieved success.

With respect to the first metric, we have seen labor market improvement since the program began last September. Over this time period, the unemployment rate has declined to 7.3 percent from 8.1 percent. However, at the same time, this decline in the unemployment rate overstates the degree of improvement. Other metrics of labor market conditions, such as the hiring, job-openings, job-finding rate, quits rate and the vacancy-to-unemployment ratio, collectively indicate a much more modest improvement in labor market conditions compared to that suggested by the decline in the unemployment rate. In particular, it is still hard for those who are unemployed to find jobs. Currently, there are three unemployed workers per job opening, as opposed to an average of two during the period from 2003 to 2007.

With respect to the second metric – confidence that the economic recovery is strong enough to generate sustained labor market improvement – I don't think we have yet passed that test. The economy has not picked up forward momentum and a 2 percent growth rate – even if sustained – might not be sufficient to generate further improvement in labor market conditions. Moreover, as I noted earlier, fiscal uncertainties loom very large right now as Congress considers the issues of funding the government and raising the debt limit ceiling. Assuming no change in my assessment of the efficacy and costs associated with the purchase program, I'd like to see economic news that makes me more confident that we will see continued improvement in the labor market. Then I would feel comfortable that the time had come to cut the pace of asset purchases.[4]

Regional economic conditions

Let me now turn to economic conditions in the region. The upstate New York economy is continuing to grow, but at a pace somewhat slower than the national economy. In part, this reflects the fact that the U.S. economy is recovering from a much deeper and more severe recession than Upstate New York. As the national economy continues to heal, places like Upstate New York, which didn't see a huge boom and bust in housing and their economies before the Great Recession, don't have as much ground to make up.

But the region's slow economic growth during the recovery also reflects the re-emergence of historical trends – Upstate New York hasn't tended to perform as well as the rest of the country during economic expansions. Like many economies in the Northeast, Upstate has tended to grow slowly in recent decades, as the population has shifted to other parts of the country and the once dominant manufacturing industry has shrunk considerably.

These same trends are playing out in the Syracuse area. Like Upstate New York more generally, the recession in Syracuse was not as deep as the nation's. However, the Syracuse area experienced a deeper recession than Upstate as a whole, losing about 13,000 jobs during the downturn. The area's recovery has lagged behind Upstate. So far, Syracuse has gained back less than half of the jobs that it lost.

Recent job growth has been led by the region's education and health sectors. Together, these sectors have added stability to the local economy and provided a foundation for growth. Over the past several years, during both recession and recovery, these sectors have added about 1,000 jobs each year to the local economy. The leisure and hospitality sector,

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[4] For more thoughts on the monetary policy outlook, I refer you to the speech made earlier this week: ***Reflections on the Economic Outlook and the Implications for Monetary Policy***.

as well as the retail sector, has also been a solid source of job growth for the area. However, as you probably well know, job losses in the region's manufacturing industry have weighed against these gains. About 9,000 manufacturing jobs have been lost since the start of the Great Recession. And, while a slow jobs recovery began in the nation's manufacturing sector in 2010, Syracuse has continued to lose these jobs in recent years – a painful process for the area to continue to endure to be sure.

Nonetheless, these trends have resulted in a more diversified economy. In fact, the share of workers employed in the metro area's manufacturing sector is now just 8 percent, just below the nation's 9 percent share. The private education and health sectors have emerged as the largest industries, and now employ one in five workers. So, the face of the local economy has changed dramatically through a somewhat painful restructuring process. But I believe this process is reaching its conclusion, and the resulting more diversified local economy is providing a strong foundation on which Syracuse can build going forward.

Hence my interest in the collaborative efforts of the business, academic and health sectors to further economic growth. These efforts capitalize on the strengths of the region and may well be a good way to further economic development not only in Syracuse but in Buffalo and Rochester as well. Each metro area has a strong university, a strong health sector and a business community all eager to find ways to leverage local assets and boost economic development.

Looking forward, I believe that the colleges and universities in Syracuse will help drive the region's economy in the years to come. Syracuse can build on these assets by continuing to make partnerships between industry and higher education a high priority. When companies and universities work together, they can become a powerful engine for innovation and economic growth. These collaborations are a key ingredient to helping improve the competitiveness of local businesses, the universities themselves, and their regions, and we should take every opportunity to exploit these partnerships as much as possible to unleash their full potential.

College graduates finding jobs

Let me finish off by saying a few words about the value of education. There is no doubt that the Great Recession and sluggish recovery that followed has made it difficult for many people to find jobs. I'm sure many of you here today are worried about finding a good job after you graduate, and you may be wondering whether going to college will turn out to have been a good investment.

Let me reassure you, despite the weak labor market conditions that have prevailed since the Great Recession, the benefits of a college degree remain significant. Research we have undertaken at the New York Fed clearly shows that young people with a college degree are more likely to have a job and they tend to earn higher wages than those without degrees – and this is true even for those who may be underemployed initially when they first enter the labor market after graduation. In fact, our research finds that to some extent, it has always proved challenging for college graduates to transition into the labor market, even during economic expansions, but as time passes, and the graduate's experience grows, the transition generally gets accomplished successfully. Although it is true that the labor market has been more difficult for college graduates in recent years, I am confident that most will find work and transition into higher-skilled jobs as they gain experience and as the labor market improves.

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