Elizabeth A Duke: Issues in economic development

Remarks by Ms Elizabeth A Duke, Member of the Board of Governors of the Federal Reserve System, at the International Economic Development Council's Federal Economic Development Forum, Alexandria, Virginia, 19 April 2010.

The original speech, which contains various links to the documents mentioned, can be found on the US Federal Reserve System's website.

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Good afternoon. I am pleased to address the International Economic Development Council's (IEDC) Federal Economic Development Forum. Before coming to the Federal Reserve, I spent 30 years as a banker, primarily as a community banker. As such, I always recognized that the strength of my bank depended on the strength of the economy in my market area. So I devoted quite a bit of time and attention to local economic development. Within my market, I served at various times on a number of public and non-profit boards and commissions focused on regional development. That experience gave me a deep appreciation of the challenges and accomplishments of those working in economic development at the local level.

As a member of the Federal Reserve Board, I am more often focused on national economic issues, though even these are heavily influenced by the collective impact of economic and community development initiatives. Nonetheless, as I prepared to come here today, I was struck by the wide range of activities and frequent interaction between the Federal Reserve System and economic development practitioners, both at the national and local level. As many of you know, the Federal Reserve System is made up of the Board of Governors in Washington and 12 Federal Reserve Banks across the country. We have specialists throughout the System who routinely promote economic development successes through outreach and educational activities. In fact, Federal Reserve staff members serve as advisers and board members to local economic development entities and even the IEDC.

We're involved in community economic development because we recognize that economic recovery, growth, and stability depend on job creation and the development of diversified and robust regional markets. I plan to focus today on the Federal Reserve's current research, policy, and related activities in three areas where, based on my experience, I believe our concerns overlap with those of economic development professionals: small business lending, commercial real estate, and workforce development.

Small business lending

This year I have been asked about the tightening of credit for small businesses more often than any other topic. Many audiences, including economists, community bankers, and the Congress are enormously concerned about the issue. Not surprisingly, the success of small businesses is important to economic developers as well. Small businesses employ nearly 40 percent of the private sector workforce, making them a key component of the job market and a building block of the economy. The health of state and local economies is directly tied to the opportunity for small businesses to prosper.

Despite the best efforts of bankers and regulators, small businesses are still finding it difficult to obtain credit. A recent study conducted by the National Federation of Independent Business (NFIB) found that only about half of the small employers who attempted to borrow in 2009 received all the credit they wanted. Nearly one-quarter received no credit at all. A similar study in 2005 found nearly 90 percent of small employers had most or all their credit needs met, and only 8 percent obtained no credit. Even though conditions in financial markets have continued to improve this year, access to credit remains restricted for many smaller businesses.

Several factors are contributing to the reduced supply of bank loans. For instance, in response to an increase in the number of delinquent and nonperforming loans, many banks have reduced existing lines of credit sharply and have tightened their standards and terms for new credit. In other cases, banks whose capital has been eroded by losses or who have limited access to capital markets may be reducing risk assets to improve their capital positions, especially amid continued uncertainty about the economic outlook and possible future loan losses.

But the reduction in the availability of credit is not the whole story. There is also less demand for credit by sound firms. As businesses reduced inventory levels and capital spending, they tended to pay down debt and build cash positions. Indeed, in the most recent NFIB study, 34 percent of businesses reported lower sales as their biggest problem while only 3 percent cited lack of credit. And while some potential borrowers seek less credit, others are no longer qualified to borrow. Weakened balance sheets, reduced income, falling real estate collateral values, and in some cases, a recent history of payment problems have made it difficult for some businesses and consumers to qualify for loans, especially under the current stricter standards.

Other factors unique to the current financial environment may also be weighing on the ability of small businesses to borrow. A significant portion of small businesses rely on the owners' personal assets and credit to fund their operations. As a result, small businesses are affected by tight consumer credit conditions, in addition to an unfavorable business credit climate. Many small business owners rely on their homes or business real estate to secure their business loans. As collateral values have declined, their borrowing capacity has been reduced. Finally, small business lending often is based on relationships that are solidified over time. Sometimes those relationships are broken as a result of the bank's inability to lend, such as when the bank fails or when it reduces lending because of strains on or concentrations in its own portfolio. Small businesses may then find it quite difficult to establish similar arrangements with a new bank.

Given the challenges facing small businesses, the Federal Reserve has sought to ease the flow of credit and better understand the nuances of the credit tightening. Ultimately, the most effective way for policymakers to improve credit availability to small businesses, as well as other businesses and households, is to undertake efforts that support a sustainable economic recovery. With this in mind, the Federal Reserve over the past two years has taken strong action in response to the financial crisis to help improve financial market conditions and promote the flow of credit to households and businesses. We have acted on multiple fronts by instituting accommodative monetary policy, expanding existing liquidity programs for depository institutions, and establishing new liquidity facilities to support market functioning. Throughout this period, we have particularly emphasized ensuring that our supervision and examination policies do not inadvertently impede sound lending to businesses, both large and small, and we will continue to do so.

In addition, the Federal Reserve System is hosting meetings with private- and public-sector partners to highlight concerns facing small businesses. Some of these meetings focus on general small business topics. Others concentrate on subsegments of the market such as minority business owners or businesses located in low- and moderate-income areas. We are in the midst of hosting more than 40 such gatherings across the country to collect data and glean perspectives that will help find ways to meet the immediate and intermediate financial needs of small businesses. These meetings seek to identify existing credit gaps, share promising practices, and highlight regional differences as well as national themes in credit access and technical support for small businesses. The key findings of these small business gatherings will be presented to policymakers later this summer.

Despite the difficulties in the small business lending market, I find reason to be optimistic about small business lending in the near future. Improvements in conditions that depressed lending in 2009 lead me to believe that we will begin to see an increase in bank loans to small businesses later this year. Notably, overall economic conditions, the most important determinant of the demand for and availability of small business lending, have improved considerably since the early and middle part of last year. In response, bank attitudes toward lending, including small business lending, may be shifting. According to the Federal Reserve's Senior Loan Officer Opinion Survey conducted in January, the number of banks that reported having eased credit standards for small business lending over the previous three months nearly matched the number that reported having tightened lending standards for the first time since before the crisis began, in the summer of 2007.[1]

Commercial real estate

I am sure that economic development professionals also are greatly concerned about the continuing deterioration of conditions in commercial real estate (CRE). A solid real estate base is not only the foundation for commercial and retail centers, but communities also depend on these commercial corridors to supply services and jobs to their residents and contribute significantly to the local tax base. I assure you that the Federal Reserve appreciates the consequences of weaknesses in commercial real estate and shares your concern.

Unfortunately, the outlook for commercial real estate is not very favorable. Hit hard by the loss of businesses and employment, much retail, office, and industrial space stands vacant. In addition, many businesses have cut expenses by renegotiating existing leases. The combination of reduced cash flows and higher rates of return required by investors leads to lower valuations, and many existing buildings are selling at a loss. As a result, credit conditions in this market are particularly strained. Commercial mortgage delinquency rates have soared. According to our January survey of senior lending officers, banks continued to tighten standards on CRE loans and, presumably in light of the poor economic outlook for the sector, appear to have been reluctant to refinance maturing construction and land development loans. In this environment, a turnaround in CRE is likely to lag the improvement in overall economic activity. However, compared with the situation in the early 1990s, the problems in this sector now appear to be due largely to poor business fundamentals rather than widespread overbuilding, suggesting that the performance of the CRE sector will gradually begin to improve as the economy continues to strengthen.

The Federal Reserve and other banking agencies issued a policy statement covering commercial real estate loans and loan workouts in October 2009 – one of a series of actions taken to support sound bank lending.[2] This guidance urges both lenders and bank examiners to take a balanced approach in assessing borrowers' debt servicing capacity and to make realistic assessments of collateral values.

In addition, the Federal Reserve has taken steps with bankers and examiners to reinforce the expectations outlined in the interagency policy statement. For example, in January, Federal Reserve staff instituted an examiner training initiative that will underscore the importance of sound lending practices with Federal Reserve and state examiners across the United States. Additionally, we have developed an interagency training program specifically for examiners reviewing CRE loans as part of the interagency Shared National Credit Program, which covers large syndicated loans, including the largest commercial real estate loans in the nation.

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1 See Board of Governors of the Federal Reserve System (2010), "The January 2010 Senior Loan Officer Opinion Survey on Bank Lending Practices".

2 See Board of Governors of the Federal Reserve System (2009), "Federal Reserve Adopts Policy Statement Supporting Prudent Commercial Real Estate (CRE) Loan Workouts", press release, October 30.

We are working hard to track the progress and effectiveness of this guidance and are exploring the feasibility of more formal statistical approaches for measuring and evaluating its effectiveness. Preliminary analysis of recent data offers some encouragement that CRE refinancing and workouts are beginning to take place. Notably, the volume of restructured troubled loans increased by almost 32 percent during the fourth quarter of 2009, the quarter in which the guidance was issued. And, while overall real estate lending continues to decline due to a sharp contraction in construction lending, loans outstanding in several other commercial real estate sectors increased modestly in the fourth quarter.

Of course, the ability of economic development experts to impact the stability of the commercial real estate market should not be underestimated. Your efforts to revive employment, retail sales, and business capital expenditures in your communities will be key to the recovery of commercial real estate values. Focusing your efforts on bringing new tenants to existing commercial areas rather than developing new areas will also help to hasten the recovery. I encourage you to be mindful of these options as you continue your work.

Workforce development

Finally, I would like to emphasize the importance of workforce development as a means for attracting and keeping businesses and jobs in your community. Few tools in the economic development arsenal are as powerful as those that successfully match workers and jobs. Federal Reserve research has uncovered a number of strategies that are especially promising for such matches. But before I get to them, let me provide some recent data on the grim employment picture that makes the success of such strategies so critical.

The unemployment rate has held at 9.7 percent for the past few months and job market conditions remain weak. While job growth in March may be the first welcome sign that the worst is over in terms of job loss, approximately 8 million jobs have been lost in the past three years, and it will take sustained, robust job growth for some time to return all those workers to jobs. Other indicators also suggest a challenging employment picture ahead. Specifically, data collected by the Bureau of Labor Statistics indicates the unemployed, on average, are remaining unemployed longer than in the past. And more people are underemployed as employers reduce costs by shifting to part-time staffing models.[3]

So far, most of the stabilization in the unemployment rate has come from a sharp reduction in layoffs and terminations. We have not yet seen any substantial improvement in hiring rates. Aggressive moves by businesses to reduce costs by cutting jobs and work hours have resulted in solid gains in aggregate productivity. This bodes well for increased employment in the coming year, but I anticipate that employers will add jobs cautiously in order to preserve these cost savings and efficiency gains for as long as possible.

Improvement in labor market conditions is clearly a key component of a sustained economic recovery. It is important to note that unemployment is not distributed evenly across all segments of the population. Men, young workers, and low-skilled job seekers are disproportionately affected by current job losses.[4] Most notably for purposes of this discussion, the prolonged unemployment of so many low-skill workers, in particular, is increasing the demand for training and education.

Retraining workers to acquire the skills demanded in today’s job market is an ongoing challenge as employment shifts away from low-skill manufacturing toward the service sector,

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[3] Bureau of Labor Statistics, U.S. Department of Labor.

[4] Bureau of Labor Statistics, U.S. Department of Labor.

technology, and health care. The recent economic crisis and the rise in unemployment have only made the need to retrain workers more urgent.

Effective workforce development is necessary to ensure that workers have the skills they need to find new employment and that communities have a consistent supply of well-qualified workers to remain competitive. Traditional workforce development strategies include pre-employment training and job placement to help low- and moderate-income people transition from one job to another. Most commonly, this involves occupational training through certificate and degree programs, but it also includes the training and development workers receive from employers.

Workforce development initiatives primarily focus on making job seekers "job ready". Given the current unemployment rate, governments and community organizations have understandably focused on projects and programs that will create new jobs and ensure that workers are available to fill them. Yet, even in this economy, some jobs go unfilled because individuals lack the necessary skills. Skill gaps could constrain long-term employment growth. Indeed, some 88 million Americans have at least one educational barrier, such as no high school degree, no postsecondary training, or deficient English language skills. And, as I noted, longer average duration of unemployment may be eroding the skills of the jobless.[5]

While broad investments in human capital and workforce development are clearly needed, it is not easy to determine how to ensure that those investments are effective and cost-efficient. The Federal Reserve System is engaged in ongoing research to identify best practices and establish methods for measuring the success of workforce development programs. For example, the System's Community Affairs function studied various workforce development needs and responses as part of its examination of the impact of concentrated poverty on lower-income individuals. In its report, *The Enduring Challenge of Concentrated Poverty in America,* published in 2008, findings from 16 case studies confirmed that a skilled labor force is a key attraction for other drivers of community success, including lower crime rates, outside investment, and access to employment. As a result, many of the case study communities actively promote strategies that address barriers to work and connect adults to employment opportunities.[6]

Among the successful strategies identified in the concentrated poverty case studies, the report noted that community colleges have effectively filled educational gaps in communities where limited educational attainment among residents and insufficient job readiness were particularly pronounced. In Cleveland, for example, residents who once worked in manufacturing lacked the necessary skills to obtain other available jobs, particularly in the growing health care sector. To address this problem, the Cuyahoga County Community College designed an innovative program to help individuals with limited formal education enter health care through a nursing assistant training program. The program offers both immediate employment opportunities and the potential for additional credentials necessary to advance to other jobs along the occupational ladder.

In El Paso, Texas, the community developed Project ARRIBA, a labor market intermediary that provides clients with training through El Paso Community College. The training focuses on the skills necessary for local job demands in fields such as health care, education, and information technology.

More recently, economists at the Federal Reserve Bank of St. Louis conducted a study of the effectiveness of community colleges in advancing the economic well-being of students and

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5 See Beth Siegel and Karl Seidman (2009), "The Economic Development and Workforce Development Systems: A Briefing Paper", (New York: Surdna Foundation, December).

6 See Federal Reserve System and the Brookings Institution (2008), *The Enduring Challenge of Concentrated Poverty in America: Case Studies from Communities Across the U.S.*

found that students who attend a community college gain economic advantages in the job market, even without completing a degree. A review of research on using community colleges for retraining older displaced workers found that one year at a community college increases the long-term earnings of those workers by about 9 percent for men and about 13 percent for women, when compared to earnings for similar workers who did not attend community college. The majority of these gains were from math, science, and other technically oriented courses.[7]

In addition to the need to bridge a substantial skills gap in many job markets, the challenge of connecting the residents of poor neighborhoods to jobs often entails overcoming informational and transportation barriers. These problems are illustrated by the Federal Reserve Bank of Boston's research and fieldwork in Springfield, Massachusetts. Springfield was one of the concentrated poverty case studies. The Boston Bank noted that Springfield residents with a high school education were less likely to be employed than similarly educated residents of comparable cities. The Reserve Bank's research found that Springfield area employers rely heavily on referrals from existing employees in the screening process for entry-level jobs. Unfortunately, many residents of the poor neighborhoods of Springfield lack connections to current jobholders, putting them at a disadvantage relative to other job seekers. In many cases, they also lack the transportation options necessary to reach potential jobs. For example, manufacturing, construction, and other jobs suitable to the residents' competencies increasingly require that they commute outside of Springfield's urban core. However, low car-ownership rates among inner-city residents and limited public transportation options during nights and weekends and to suburban locations can exacerbate the challenges of connecting with job opportunities. As a follow up to the case study, the Boston Bank recommended expanded training, internship, mentorship, outreach, and other programs designed to develop Springfield's human capital and job market connections. Moreover, the Reserve Bank has encouraged employers and public officials to devise solutions to address commuting difficulties.

Meanwhile, the Federal Reserve Bank of Richmond also identified transportation for low-income workers across the country as an important barrier to income stability. The Richmond Bank found that higher-paying jobs tend to be located on the outer fringes of metropolitan areas, at a distance from many people seeking jobs. Moreover, many of the jobs in growth sectors, such as health care and technology, tend to have varying shifts, which makes using public transportation difficult. The Richmond Bank co-hosted an event, *Cars and Working Families,* to build support for the concept that car ownership has become a necessity rather than a privilege for working people. The event highlighted some of the barriers to auto ownership among lower-income workers, including the cost of insurance, mandatory driving classes that are primarily taught in English, and significant license fees. Since then, the Richmond Bank has undertaken an initiative to focus community organizations, community development foundations, and the financial industry on the importance of car ownership to a person's ability to hold a job that pays a living wage.

As you can see, the Federal Reserve is not only working to improve the national economic outlook, but it is also engaged in some very local initiatives designed to identify and address barriers to employment for those most impacted by recent job losses. We are committed to continue lending our research and outreach resources to assist in these and other promising community economic development initiatives.

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[7] See Natalia Kolesnikova, Federal Reserve Bank of St. Louis (2009), "Community Colleges: A Route of Upward Mobility".

Conclusion

In conclusion, I commend the work that you do in communities across the country. Having been involved in several economic development initiatives as a community banker, I know how complicated it is to build vision and consensus among local stakeholders. While current economic circumstances are challenging, the work you do has never been more important to the communities you serve. I hope that the Federal Reserve's activities in the areas of small business, commercial real estate, and workforce development that I described have given you an insight into how we are trying to mitigate the economic downturn's impact on communities. We look forward to continued dialogue and partnership with you as we seek to find ways to hasten recovery and rebuild communities.