

William C Dudley: Regional economy and housing update

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, 19 October 2010.

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Good morning and welcome once again to the New York Fed's Quarterly Regional Economic Press Briefing. As always, 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 the housing sector in the nation and especially the Second Federal Reserve District, which covers New York, northern New Jersey, Fairfield County, Connecticut; Puerto Rico and the U.S. Virgin Islands. My colleagues will follow my remarks and provide more detail. As always, what I have to say reflects my own views and not necessarily those of the Federal Open Market Committee or the Federal Reserve System.

National economic conditions

To provide context, let me start with a few comments about national economic conditions. As I discussed in a recent speech, the long and deep recession that ended in June 2009 has been followed by a very tepid recovery. Since June 2009, economic activity has grown – but only slowly from levels far below the productive capacity of the economy.

In recent months, the momentum of the recovery has slowed. For example, after rising at a 3.25 percent annual rate during the second half of 2009, there has been a progressive slowing – to a 2.75 percent annual rate during the first half of 2010 and, most likely, to an even slower rate when the third-quarter real gross domestic product (GDP) figures are released at the end of this month.

With demand growth barely keeping pace with firms' ability to increase productivity, job creation has been too weak to significantly reduce unemployment, which stands today at 9.6 percent. And, as is typical in such circumstances of considerable slack, the rate of inflation has declined.

Viewed through the lens of the Federal Reserve's dual mandate – the pursuit of the highest level of employment consistent with price stability, the current situation is wholly unsatisfactory. Given the outlook that the upturn appears likely to strengthen only gradually, it will likely be several years before employment and inflation return to levels consistent with the Federal Reserve's dual mandate.

Why are we experiencing this soft patch now? There are several reasons:

- As is typical for the early stages of a recovery, the economy over the past four quarters has benefited from a strong inventory cycle. The swing in inventories from liquidation back to restocking contributed about 1.75 percentage points of the 3 percent growth of real GDP over that period. But this effect is now petering out.
- The growth impulse from the 2009 fiscal stimulus package is beginning to wane.
- The usual hand-off from inventory-led growth to private final demand is not yet fully established.

Instead, we have ongoing sluggishness in two key sectors that have led past recoveries: consumer spending and housing.

The slow recovery of consumer spending and housing in the face of very substantial monetary and fiscal stimulus reflects the painful unwinding of the dynamics at work during

the expansion that preceded it. Beginning around 2003, underwriting standards for residential mortgages were significantly relaxed, leading to a sharp rise in household borrowing and in home prices. The rise in home prices helped to support additional demand for credit as households used the collateral represented by their homes to borrow large sums of money via home equity lines of credit and second mortgages. This also fueled a strong boom in home construction. But house price increases could not be sustained without limit. When home prices peaked and started to turn down, the dynamic linking house prices, credit and consumption went into reverse, forcing substantial adjustments on the part of the household sector and in the housing market itself.

I've discussed in recent speeches the role monetary and regulatory policy can play in helping to support economic activity and in improving economic outcomes relative to what would otherwise be experienced in the absence of this support. These steps include critical reforms that make the financial system safer and accommodative monetary policy that make mortgages more affordable and make the investments that create jobs are more attractive. Today I will focus on the economic trends themselves.

Let's consider first the consequences of this dynamic for consumer spending – that is, households' purchases of goods and services. Families' expenditures rose at a slow 2 percent annual rate over the first half of 2010 and (so far) this sluggishness appears to have continued in the third quarter of 2010. Families have not yet boosted their spending above the levels preceding the severe cuts they made during the recession. This frugality stands in stark contrast to the first year of recovery from previous deep recessions. Several factors are inhibiting families from spending. Many people have lost their jobs and are still unemployed, or have had their hours or pay reduced. Confidence in the economy remains quite low. And households' net worth, which fell substantially as real estate and stock prices dipped, remains well below its previous peak compared with disposable income. So, households have been saving more. The personal saving rate, which rose to 5.5 percent by the end of 2009 from a recent low of 1.2 percent in the third quarter of 2005, seems headed even higher in the third quarter. Households are "deleveraging"; they are paying down their debts. Of course, lenders have also reinforced this tendency as they have tightened underwriting standards for consumer credit, relative to their pre-recession standards.

Have households completed their deleveraging, so they will soon spend more? Although we believe that substantial progress has been made, it is hard to tell how much further this process has to run. For example, the share of household after-tax income that families owe for servicing debts and paying for housing (including property taxes, homeowners insurance and rents) has declined sharply over the past two years and is now back to levels last seen in the late 1990s. Households have cut the total amount of debt they owe. They are also refinancing outstanding debt to take advantage of the lowest mortgage interest rates since the mid 1950s. We expect the increased rate of mortgage refinancing now in place to continue over the near term. This represents another means by which households can free up income for other uses.

Now, let's consider the slow housing recovery. Housing market activity – both new construction and sales – remains depressed. On the construction side, total housing starts are running at just 600,000 units per year (seasonally-adjusted) in recent months. This is up from 530,000 units at the trough in the first quarter of 2009 but it is still extremely low by the standards of the last 50 years. In fact, the rate of new construction is so low that there is barely any net growth in the U.S. housing stock these days.

One reason why so little housing is being built is that many existing homes stand vacant. We estimate that there are roughly 3 million vacant housing units more than usual. And more vacancies are added daily as the foreclosure process moves homes from families to mortgage lenders. This stock of vacant homes will shrink when fewer are foreclosed upon and more of these homes are sold or rented out.

On the sales side, even though low mortgage interest rates and falling home prices have together boosted housing affordability to its highest level in 40 years, the current pace of sales is quite sluggish. Impediments to home sales include tight lending standards, a weak job market and continued uncertainty regarding the future path of home prices. The large decline in home prices that occurred between 2006 and 2008 is also important. This decline reduced the amount of equity that owners have in their homes, making it difficult for people to come up with the funds needed to “trade-up” and move into better homes.

In addition, the steep decline in home prices put many families at risk of mortgage delinquency and, ultimately, losing their homes to foreclosure. With lower home prices, many families now owe more on their mortgage than their home is worth. This means that they cannot refinance or sell their homes easily if they experience a financial crisis, such as a job loss or a serious illness. Recent developments on foreclosures have been mixed. While RealtyTrac reports that foreclosure completions in the United States exceeded 100,000 for the first time in September, it is important to remember that foreclosure is a lengthy process in most states. Our data indicate that, in recent quarters, borrowers are becoming less likely to fall behind on their mortgages, so fewer households are now entering the foreclosure process. At the same time, though, major lenders have acknowledged serious problems in the processes they have used to repossess homes and announced moratoria on new foreclosures. Taken together, these developments suggest that the situation in housing remains uncertain for the foreseeable future.

The Federal Reserve actively encourages efforts to find viable alternatives to foreclosure, like loan modifications, or deeds in lieu. We also support due process and access to legal counsel for homeowners facing foreclosure, for instance through legal aid programs. At the same time, it is important that foreclosures that properly comply with state and federal law can ultimately take place, as this is a necessary part of the adjustment that will eventually return us to more normal conditions in the housing market.

At present, the extent of the documentation problem and its wider ramifications are still uncertain. In conjunction with the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation, the Federal Reserve is therefore seeking to establish the facts through a review of the foreclosure practices, governance and documentation at the major bank mortgage servicers. We want to ensure that the housing finance business is supported by robust back-office operations – for processing of new mortgages as well as foreclosures – so that buyers of homes and investors in mortgage securities have full confidence in the process. We are monitoring developments closely in order to evaluate any potential impact on the housing market, financial institutions and the overall economy.

The key role that housing has played during this recession and recovery makes it a timely topic for our regional economic briefing.

Regional economic conditions (update since the July regional press briefing)

Now, let me turn to regional economic conditions. Overall, the recession seems to have been less severe in much of our region than in many other parts of the country, though unemployment remains unacceptably high.

As attendees at previous Regional Press Briefings may recall, the New York Fed produces Coincident Economic Indicators to help track the performance of the regional economy. Since July, these indicators point to recovery in New York State, and particularly in New York City.

Although New York City and New York State are recovering, elsewhere in the region, the story is different. In New Jersey, although activity is no longer declining, there has yet to be a sustained recovery. New Jersey’s economy remains essentially flat. An index produced in Puerto Rico by the Government Development Bank shows that the pickup in economic

activity there in late spring and early summer has retreated and activity in the past few months has again turned down.

Now, let's look at jobs, which are the key for people to truly feel the recovery in their lives. I am pleased to note that private-sector jobs have continued to grow moderately across much of the region in the past few months, just as they have in the nation. Growth in private-sector jobs – which is not affected directly by hires and layoffs from the decennial census – signals that, on balance, firms are expanding their workforces to meet their business needs. While state and local government job cuts have also reduced total employment, the fact that the private sector is creating jobs is a good sign and necessary for a sustainable recovery.

The number of private-sector jobs has increased in and around New York City, in northern New Jersey and in some parts of Upstate New York. The latest job market report for New York shows a continuation of the generally rising trend of employment in the state at a pace that roughly matches the nationwide growth rate. In New York City, employment has expanded at rates substantially above the nation. Since we last met, employment in New Jersey has expanded, and while that growth has been quite modest, it is an encouraging sign. In Puerto Rico, employment reports continue to give mixed signals, showing a see-saw pattern that has yet to add up to a strong rebound.

Despite these employment gains, unemployment in the region remains painfully high. In August, New York City's and New Jersey's rates were very close to the national jobless rate of 9.6 percent. The rate for New York State, which has been improving since the first quarter, is noticeably lower at 8.3 percent. Puerto Rico, which has had much higher unemployment than the mainland for the past several decades, saw a modest decline in its jobless rate, but at 15.6 percent is still showing little evidence of a recovery.

Regional housing trends in New York and New Jersey

We focus on housing at today's briefing because it represents the most important asset that many households own, provides a substantial number of high-wage jobs and is often a key driver of regional as well as national business cycles.

I'll start with a key observation: During this recession, the housing sector contributed less volatility to the regional economy than it did in much of the nation. We have, of course, seen painful losses of homes, construction jobs and housing equity in New York and northern New Jersey. This pattern can be seen quite directly in the construction sector, where many jobs were created during the housing boom, but then were lost as the housing market deteriorated. However, our housing markets tend to be less influential in our economy because we are a relatively mature region. That is, we are not adding population as rapidly as some other parts of the country, so housing construction – which tends to be very cyclical – and associated purchases account for a smaller share of aggregate activity here than it does in faster growing regions.

In addition, much of our region was spared the worst effects of the non-prime mortgage boom and bust. There was generally lower penetration of nonprime loans into our housing markets, and in general, our region shows better performance, with fewer delinquencies and foreclosures. This pattern was particularly true across Upstate New York. However, as can be seen on the New York Fed's U.S. Credit Conditions maps, there are significant pockets of housing distress around the greater New York City metro area, especially in communities in the Bronx, Dutchess County and Long Island. Indeed, we recently documented the severity of problems on Long Island in our *Facts and Trends* publication. Moreover, New Jersey had non-prime mortgage activity closer to the national average and now has more delinquencies and foreclosures than is the case for much of the region.

As the uneven pattern of nonprime lending suggests, the region is hardly uniform. The housing section fared better in Upstate New York than it did in much of the region during the

recession. In fact, the housing boom and bust largely bypassed Upstate New York, where construction activity is a relatively small part of the overall economy.

Relative to Upstate New York, most areas in downstate New York and northern New Jersey more closely tracked the national cycle. Sales activity and home prices ramped up during the housing boom, but then dropped sharply.

More recently – over the past year – home sales and prices in the region have followed different paths. Home prices have generally stabilized across upstate New York, with some parts, such as Buffalo, Rochester and Syracuse, even experiencing price increases over this period. However, home prices have continued to decline in the greater New York and New Jersey area. By contrast, the number of home sales have generally increased throughout the region over the past year. But the pattern has been erratic because of various policy changes. In particular, the introduction, initial expiration and subsequent extension of the home buyer tax credit introduced volatility as it boosted, slowed and then boosted sales again. With the final expiration of this tax credit, the recent rise in home sales across New York and northern New Jersey may well be short-lived.

Regional housing trends: focus on New York City

I'll end with a few remarks about New York City's housing market – a very large market that stands out as unique in many respects.

Let me remind you of some of these key differences:

- Compared with the rest of the region, and with the rest of the country, New York City has an exceptionally large share of rental housing: 67 percent of homes citywide versus 33 percent for the United States.
- The market is dominated by multi-family structures, especially in Manhattan and the Bronx. When these units are owner-occupied, they are more likely to be co-ops than condominiums, and, thus, to have comparatively low leverage rates.
- New York City has very high housing prices and long construction lags. Since the number of homes cannot adjust quickly, rising demand during a boom typically leads to rapid rises in prices and unregulated rents. Eventually, of course, the amount of housing supplied responds to changes in demand.

So, how did the economic expansion and contraction affect New York City's housing market? For a mature city, the city saw an unusually strong boom in housing sales, construction and prices. This expansion actually began in 1996 and continued even in the aftermath of the 9/11 attack. Since 2007, however, New York City's market has turned down. This decline started later than the nation's and prices have fallen less sharply. Now, prices appear to have stabilized.

This pattern can also be seen in Manhattan's rental market. After a long period of rising rents, the market weakened substantially from 2007 to 2009, and rents have rebounded moderately in 2010.

New York City has not been spared from the high rates of mortgage delinquencies characteristic of this recession. Manhattan's delinquency rates are elevated although they remain markedly below the national average. By contrast, pockets of distress are much more prevalent in the outer boroughs, all of which have delinquency rates, per owner-occupied unit, above the national average.

The relatively mild recession and the recovery in the City are lending support to both home prices and sales. Also positive, compared with the rest of the country, are the City's low mortgage leverage rates and a low share of homes with underwater mortgages.

Nevertheless, several risks to home prices in the City remain. These risks include the ongoing completion of a considerable number of new apartment buildings – ones that were started at the end of the boom. Another risk comes from the slow pace of job growth in high-pay sectors (including the securities industry) in New York City. Finally, during the boom, prices rose substantially faster than rents. Going forward, this disparity could exert downward pressure on home prices as renting has become a more affordable alternative.

Conclusion

In sum, after a recession that was milder than in many parts of the country, the region is showing signs of a modest recovery in New York, but little growth elsewhere. The housing sector played a pivotal role in the recent national downturn. In the region, the fact that housing activity has a smaller weight in the regional economy helped to limit the recession's impact on many communities. Going forward, given housing's significance to the well-being of people in our region and beyond, the New York Fed will continue to focus on the sector as we monitor regional and national economic conditions.

Thank you for your kind attention. I will now ask James Orr to provide more details on current regional economic conditions.