William C Dudley: How goes the recovery? Challenges for the nation, the region and the Fed

Remarks by Mr William C Dudley, President and Chief Executive Officer of the Federal Reserve Bank of New York, at Cornell University, Ithaca, New York, 25 October 2010.

* * *

Good morning. I am pleased to have this opportunity to speak to you as I travel through Upstate New York to meet with various communities in the region. This afternoon I will focus on national and regional economic conditions and what the Fed is doing about them – with particular attention to the housing sector and to conditions in Upstate New York. 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.

Introduction to the New York Fed

As many of you know, this is my first chance to speak at Cornell University since I became president of the New York Fed. So, by way of introduction, let me start with a synopsis of what the New York Fed is, what we do and what makes my job so interesting.

The New York Fed is part of the Federal Reserve System, America's central bank, and was created by Congress in 1913. With this act, Congress delegated to the Fed System its constitutional authority to manage the money supply – and designed it be decentralized, representative of all of America and independent of the political process. The Fed System is comprised of the Board of Governors in Washington, D.C. – a federal agency led by Chairman Ben Bernanke – plus 12 autonomous Reserve Banks that span the country. For example, the district overseen by the New York Fed includes all of New York, the 12 northern counties of New Jersey; Fairfield County, Connecticut; Puerto Rico and the U.S. Virgin Islands. Each Reserve Bank is autonomous, with its own charter and a board of directors drawn from its district, but overseen by the Board of Governors. The law that created the Federal Reserve made us independent so we can make decisions in the national interest free from political pressure. However, the Fed is accountable to Congress.

Congress has set an explicit objective for monetary policy: To pursue the highest level of employment consistent with price stability. This objective is often referred to as our "dual mandate," because it combines two goals: high employment, and low and stable inflation. In order to promote these objectives, we also pay close attention to financial stability, because without financial stability, it is very hard to achieve our goals for jobs and inflation.

The FOMC meets in Washington, D.C., eight times per year to deliberate and vote on monetary policy. As New York Fed president, I am vice chairman at these meetings and have a permanent vote. At these meetings, the 16 other members (the Board of Governors and the other Reserve Bank Presidents) and I each present our current outlook for the economy. For these assessments, we augment input from our research departments with critical information about local economic conditions supplied by our boards of directors, regional advisory councils and conversations with local stakeholders. You may know that one of my councils, the Upstate New York Regional Advisory Board, is designed specifically to provide me with timely information from this area. In this way, decisions by the FOMC are continually informed by views gathered from all parts of the country, including Upstate New York.

One thing that makes my job even more interesting is that New York has some roles unique within the Fed. Let me tell you about some of them. We, alone, implement monetary policy. At the direction of the FOMC, we buy and sell Treasury securities. We are also the eyes and ears of the Fed on Wall Street, and we supervise many of the largest financial institutions in the country. We operate Fedwire® – the conduit for large money transfers between banks. And, we provide banking services to the U.S. Treasury, and central banks and governments from around the world. Finally, I must mention that the New York Fed's district could be the most diverse in the System: ranging from the urban density of Manhattan to the forested sparseness of the northern Adirondacks, to the Caribbean islands of Puerto Rico and the Virgin Islands. All in all, there is a lot to keep my colleagues and me quite busy – even in normal times.

The crisis and response

Of course these are anything but normal times. The financial crisis that broke in mid-2007 and intensified dramatically following the failure of Lehman Brothers has been among the most virulent ever. And it was followed by the longest and one of the deepest recessions since World War II, called by many the "Great Recession."

The Fed responded aggressively and creatively in an effort to pursue our dual mandate. Our actions fell into two broad buckets.

First, we took steps to supply liquidity to the financial system, so that financial markets could continue to function properly and to enable households and businesses to maintain access to credit. Carrying out an age-old central banking role, we loaned funds to financial firms, secured against their high-quality collateral.

Traditionally, such loans were only made to depository institutions, such as banks. Of course, the modern U.S. financial system includes many lenders that are not banks. These companies and markets provide vital financing for credit card loans, short-term business needs and many other activities. Many years ago, Congress gave the Fed the emergency authority to lend to nonbanks in "unusual and exigent circumstances." During the crisis – in order to limit damage to the wider economy – we exercised this authority to lend to a wide variety of financial firms and markets.

A handful of times, we made the difficult decision to make emergency loans to prevent the disorderly failure of particular firms. We did so not because we wanted to help the firms, but because allowing them to collapse in a disorderly fashion in the midst of a global crisis would have harmed households and business throughout the United States. All the Fed's loans were collateralized and we are confident they will be repaid in full.

Second, we took aggressive steps to ease monetary policy in order to support economic activity and employment. By the end of 2008 we reduced short-term interest rates to virtually zero – the lowest level in the history of the Fed. In order to provide still further support for the economy, we bought more than $1.5 trillion of long-term assets – principally mortgage bonds guaranteed by Fannie Mae and Freddie Mac with the support of U.S. Treasury – between December 2008 and March 2010.

When the Fed buys long-term assets, it pushes down long-term interest rates. This supports economic activity in a number of ways, including by making housing more affordable and boosting consumption in households that can refinance their mortgages at lower rates. In addition, low long-term rates reduce the cost of capital for businesses, thereby fostering more hiring and investment spending (on equipment, construction and machinery, for example) for any given economic outlook.

National economic conditions

So where are we today? Let me start my discussion of economic conditions with a few comments about national economic conditions.

As I discussed in a recent speech, the Great Recession has been followed by a tepid recovery. Since June 2009, economic activity has grown – but not robustly.

In recent months, the momentum has slowed. After rising at a 3.25 percent annual rate during the second half of 2009, real gross domestic product growth has slowed. 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.

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

- In its first year, this recovery – as is typical – benefited from firms replenishing their inventories. 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 support more borrowing as households used lines of credit and second mortgages to tap into their rising home equity. 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.

Let's consider first what this means for consumption. Consumption of goods and services rose at a slow 2 percent annual rate over the first half of 2010 and with no sign of a rebound. Several factors are inhibiting families from spending, including: job or income losses, low confidence and declines in wealth as real estate and stock prices dipped. Households have been saving more and paying down their debts. Of course, lenders have also reinforced this tendency with tightened underwriting for credit relative to prerecession 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.

Now, let's consider why housing market activity – both new construction and sales – remains depressed. One reason for this is that many existing homes stand vacant. We estimate that there are roughly 3 million vacant housing units more than usual. This stock of vacant homes will shrink when foreclosures fall and more empty 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 about home prices. Importantly, the large drop in home prices between 2006 and 2008 also reduced homeowner equity broadly, making it more difficult to "trade-up" and move into better homes.

With lower home prices, many families now owe more on their mortgages than their homes are worth. This means that they cannot refinance or sell their homes easily if they experience a crisis such as a job loss or a serious illness. Foreclosure completions are at an all-time high, although the initiation of new foreclosures may be finally slowing. Recently, attention has focused on cases where some of the documentation used in the foreclosure process may have been flawed. The Fed actively encourages efforts to find viable alternatives to foreclosure. Not many people know this, but a team of New York Fed officials work with mortgage counselors and community activists to support distressed homeowners, and our lawyers support legal aid programs for people facing foreclosure. At the same time, it is important that foreclosures that comply with the law can ultimately take place. This is a necessary part of returning the housing market to more normal conditions.

Along with two other agencies, the Fed is reviewing the foreclosure practices at the major bank mortgage servicers. We are also keeping an eye on banks' potential liabilities where they made representations about mortgages bought by investors that may not have been correct in all cases. 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 homebuyers and investors have full confidence in the process. We are monitoring developments closely in order to evaluate any potential impact on housing or financial markets and the overall economy.

Economic conditions in Upstate New York

Now let me turn to economic conditions in Upstate New York. It is no secret that this region has struggled with weak economic growth and population loss in recent decades. The region has experienced some very painful economic restructuring, particularly as it lost so many of its high-paying manufacturing jobs. Yet the process has yielded a productive and more diversified economy, with a larger service sector. For this and other reasons I will discuss, the Upstate New York economy has weathered the Great Recession relatively well.

While the Upstate economy generally underperformed the nation during the 1980s and 1990s, its recent experience has been quite different. During the Great Recession, Upstate New York's job losses began later than they did for the United States as a whole, and those losses were generally less severe.

The relatively strong economic performance of the region of late is clearly tied to its stable housing markets. Upstate New York's relatively slow economic performance and lack of population growth during the expansion in the 2000s supported only modest increases in home prices and sales during the housing boom. When home prices and sales began to decline quite rapidly in many parts of the nation, they held steady across the region. As a result, Upstate New York has largely been spared the boom-and-bust cycle in housing that occurred in other parts of the country. In fact, many of Upstate New York's metropolitan areas even experienced home price appreciation during the housing bust, making these places among the best performing in the country during this period. Many parts of the country experienced severe housing busts, with sharp drops in housing-related activity (such as construction and purchases of major appliances). For example, in fast-growing places such as California and Florida, construction jobs grew to be a large share of employment, but the number of these jobs then plummeted during the recession. This dynamic did not occur in places like Ithaca, where the housing sector was small and thus, had few jobs to lose.

Another part of the story is that homeowners in Upstate New York did not take on as much debt, and households have been less strained here than elsewhere. One reason is that home prices did not appreciate rapidly here, so homes remained affordable. Moreover, there was generally lower penetration of risky nonprime loans into the region's housing markets. So, Upstate New York's home loans have generally performed better than elsewhere in the country, with fewer delinquencies and foreclosures. Indeed, much of the region was spared the worst effects of the nonprime mortgage boom and bust.

Thus, compared with other parts of the nation, the Upstate economy has performed well over the past few years. As a large and growing sector, local colleges and universities have surely contributed to the region's economic stability over the past few years. Indeed, Cornell provides a clear example of how a university can play a key role in its local economy. The benefits of the higher education industry go beyond their direct economic contributions, such as employment and spending, for a very important reason: they can increase a region's stock of human capital – that is, the total supply of knowledge and skills in its workforce.

A region's human capital contributes to its economic success and resiliency. The educational activities of a region's colleges and universities help build the skills of the local workforce. In addition, the knowledge created by colleges and universities through research activities can play a key role in starting and supporting local businesses. Businesses can use university expertise, infrastructure and research findings to help them develop cutting edge products and services. Furthermore, universities often employ local businesses to develop and commercialize products that arise from their research activities. This dynamic can expand local economic activity and consequently create new jobs for high-skilled workers in a region.

These dynamics are clearly visible in Ithaca, where a large number of local companies – in industries ranging from information technology to medical equipment to agriculture – are closely tied to Cornell. Many of these companies were started by Cornell's faculty and students and have remained in the local economy to stay connected to the university. Other companies have been attracted to the region because of the access afforded to specific knowledge or new products and processes invented at Cornell. Higher education institutions such as Cornell play a vital role in upstate New York's economy.

The relative stability of the higher education industry has, not surprisingly, contributed to a strong economic performance in recent years. Ithaca's housing market is among the healthiest in the state, and it has experienced relatively strong employment growth during and since Great Recession. Indeed, unlike most of its Upstate peers, Ithaca has gained population throughout the past decade.

What is the Fed doing now?

Since the beginning of the downturn, the Fed has actively used monetary and regulatory policy to help support economic activity and improve economic outcomes – here in Ithaca and across the nation – relative to what would have happened in the absence of this support.

With regard to monetary policy, the Fed has in place a highly accommodative stance. The FOMC has said that it will keep short term interest rates at exceptionally low levels for an extended period of time. The Fed also retains large amounts of mortgage-backed bonds acquired in order to support the housing market and help bring down mortgage and other long-term interest rates to the historically low rates in place today.

The FOMC and the Chairman have stated their commitment to take further actions to bring interest rates down further should economic conditions warrant. In a recent speech, I said that both the current levels of unemployment and inflation and the timeframe over which they are likely to return to levels consistent with our mandate are unacceptable. I said that I thought further Fed action was likely to be warranted unless the economic outlook were to evolve in a way that made me more confident we would see better outcomes for both employment and inflation before too long.

Turning to regulatory policy, the biggest lesson of the financial crisis is that severe financial disruptions can inflict very large and persistent costs on people's lives and jobs. Over the past year, with Fed leadership and support, important new regulatory initiatives have been advanced to create a global financial system where the players cannot slide back into the risky "business as usual" that created this crisis. These include the recent agreement with international bank regulators (sometimes called "Basel III") to impose stricter standards for globally active banks and the considerable regulatory changes embodied in the Dodd-Frank Act.

These measures recognize that to avert or contain future financial crises, we need a financial system that can withstand large negative shocks. First, market participants must not have incentives to take excessive risks. Instead, incentives should reward actions that support economic growth and financial stability. And financial firms must set aside enough capital and liquidity so that when things go wrong they can absorb losses with their own resources. Finally, if these buffers prove inadequate and a financial firm veers toward failure, the official sector needs the tools to wind them down in an orderly manner without having to make the terrible choice between a chaotic failure that harms the whole economy and a taxpayer-funded rescue.

Conclusion

I appreciate the opportunity to talk to you about how my job at the New York Fed ties in with your lives and work here in Upstate New York. The links are many, including

- How the Fed's dual mandate for full employment and stable prices guides our actions and affects your lives;
- How we rely on understanding economic conditions in Upstate New York as input when we formulate our policies; and
- How our efforts to restore financial stability have provided a more solid foundation for lending to households and businesses – including small businesses.

To summarize conditions at the moment: after a recession that was milder in Upstate New York than in many parts of the country, the region is showing signs of a modest recovery. A more diversified, more knowledge-based economy and a relatively small housing sector helped to limit the recession's impact on many communities. Nevertheless, the Great Recession spread much pain throughout this region and unemployment remains much higher than we would like.

The Fed cannot wave a magic wand and make the problems remaining from the preceding period of excess vanish immediately. But we can provide essential support for the needed adjustments. Even with our best efforts, the road to full recovery here in Upstate New York and across the nation is likely to be long and bumpy. But I am confident that we will make it. And, the dynamism that is represented in this room – the private sector combined with academic learning and research – will provide a strong underpinning for future prosperity.

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