William C Dudley: Regional and national economic conditions

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), before the Morris County Chamber of Commerce, Florham Park, New Jersey, 18 September 2012.

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Good afternoon, I am pleased to be in northern New Jersey to address the 8th Morris County Economic Development Corporation (MCEDC) Business Growth Forum – an annual event organized by the Morris County Chamber of Commerce. It is always a pleasure to speak with the business community and I thank you for inviting me here today.

I get out of my office in New York City regularly to inform myself – first-hand – about economic conditions and challenges across the second Federal Reserve District. Each visit within the region helps me to strengthen relationships with the diverse people of this District and build a deeper understanding of the economic challenges that we face. Today, I want to talk a bit about the Fed – what we do and why we do it. Then I'll provide some thoughts about the national and local economic outlook. Normally in these regional outreach speeches I say little about monetary policy. But since the Federal Reserve made some meaningful decisions last week and it is important for people to understand the reasons and motivations for our actions. I will conclude with a brief discussion of policy.

After that, I'll be happy to answer any questions you have about what the Fed does and why, and 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, also known as the FOMC.

What the new York Fed does

By way of introduction, I will briefly review what my colleagues and I do at the New York Fed. The New York Fed is one of 12 regional Federal Reserve Banks that, together with the Board of Governors in Washington D.C., make up the Federal Reserve System, our nation's central bank.

The Federal Reserve is independent within government. By law, we are charged with managing the nation's monetary policy – taking actions that raise or lower interest rates to promote full employment and price stability. The Federal Reserve is also charged with promoting financial stability, without which we cannot achieve our economic objectives. We play an important role in the nation's payments and settlements system, which you might think of as the plumbing of the financial system. And we have a specific mandate to promote economic development in each of our regions.

As president of the New York Fed, I serve as the vice chair of the FOMC, the Federal Reserve committee that meets eight times a year in Washington to set interest rates and make other decisions about monetary policy. The members of this committee all strive to achieve our statutory mandate. Sometimes we have different views on the specific policy choices at hand, and you should view this as completely appropriate: these are hard questions – particularly during difficult economic circumstances such as we face today.

In fact, I think we make better decisions as a committee because we don't all think alike. But we are united in our commitment to our dual mandate of maximum sustainable employment and price stability and in our belief that preserving the independence of the Federal Reserve in making monetary policy decisions is very much in the public interest. That independence allows us to make tough decisions based on data and analysis insulated from short-term political pressures.

At FOMC meetings, each Committee member presents a current outlook for his or her region and for the nation. In formulating these assessments, we consult with many sources – our boards of directors, regional advisory councils, community leaders and other key stakeholders. My meeting with you and others today is part of this systematic effort to understand what is going on in the grassroots of our economy. To help me gather more information about our region, I met this morning with Fox Valve, a small business in Dover that manufactures specialized, highly engineered industrial parts. After that, I had the pleasure of participating in a roundtable discussion with members of the local Mexican-American business community. After this lunch, I will travel to Picatinny Arsenal to learn about its role in the state's economic activity. I'll also meet with the leaders of New Jersey Community Capital to learn about their cutting-edge programs for helping distressed homeowners and then I'll speak to the students, faculty and alumni at Montclair State University.

In addition, my colleagues and I at the New York Fed continually track conditions in our District, and we have created a number of tools for that purpose. For example, my staff produces indices of economic activity for New York City, New York State and New Jersey. We also track local household credit conditions, including the amount and type of personal debt and whether payments are being made in a timely way.

We also conduct a periodic poll about the credit needs of small businesses, which are an important source of new jobs in the region. In our latest poll of several hundred firms, many report that they did not apply for credit because they were "discouraged." Perhaps surprisingly, many of these non-applicants have credit profiles similar to other firms who successfully sought credit. This finding suggests that the demand for credit could pick up as some "discouraged" firms learn that they might be able to obtain credit now.

If you, as a representative of a small business, would like to participate in our next poll, please pass your card to my colleagues, who are in the audience, or see me after the speech and we will be glad to add you as a respondent.

To promote economic development in our local communities, we publish a lot of data and analysis on the local economy, including our small business poll findings. In addition we provide education outreach initiatives to help small businesses. For example, in October, we will host a workshop in Newark to help local businesses learn about export credit facilities and new tools for marketing. At the same time, we will launch our annual financial awareness video competition aimed at helping young adults make sound personal financial decisions.

As you know, even states as wealthy as New Jersey 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 informed by analysis that suggests that high levels of foreclosures affect the value of neighboring homes, the local tax base and economic vitality more broadly. We have provided housing counselors and community development groups with the latest information on mortgage conditions, via mortgage briefs, roundtables, presentations and newsletters – including an interactive tool on our website that shows monthly delinquency and foreclosure conditions at the local level. This fall we will host a conference on distressed residential real estate to share what we and leading experts have learned with senior policymakers and practitioners from across the United States.

All in all, there is a lot to keep myself and my colleagues busy.

Regional economic conditions

So how is our region doing? Let me start by saying that New Jersey is well-positioned to prosper. New Jersey is the 11th largest state – with a population of 8.8 million and this population is well-educated. Roughly 35 percent of adults over 24 years old have a college degree, well over the national average. Here in Morris County, that figure is almost

50 percent. The state is also quite ethnically diverse: roughly 20 percent of New Jersey residents were born abroad.

The state's economy is industrially diverse, resembling the nation. New Jersey employs many people in healthcare, professional and business services, wholesale and retail trade, and leisure and hospitality. In the northern part of the state, we see a disproportionate share of jobs in a few industries: finance, particularly in Hudson County; goods distribution, related to the ports, rail lines and trucking and warehousing activities that are prominent here; pharmaceuticals manufacturing and R&D; and private education.

The area obviously benefits from its important links to New York City. In particular, many residents of this area, including myself, commute each day to the city.

So how is the recovery proceeding here? Based on the New York Fed's indices, economic activity in the state did not begin to recover until November 2010, more than a year after the nation and New York City. Since then, activity has recovered at a moderate pace, although we are still operating below our previous peak.

Employment in New Jersey declined substantially during the downturn. Our employers cut about 250,000 jobs. This represents a 6 percent loss – roughly on par with the loss nationwide. Less than one in four of those jobs have been recovered to date, slightly weaker than the nationwide recovery and, of course, much weaker than I would like to see. Over the past year, the private sector has seen moderate job gains led by some of the key sectors I mentioned earlier, particularly professional and business services, education and health, and leisure and hospitality. But the state continues to shed jobs in manufacturing and there has been little recovery in construction. State and local government cut back employment substantially during 2010, though there has been a modest pick up over the past year.

Unemployment among New Jersey residents remains high. July's reading of 9.8 percent puts the state's rate well above the U.S. average.

More broadly, how are the state's families faring financially? While the median household income among New Jersey families is the second highest in the nation – at about $69,400 – roughly a tenth of residents live in families with incomes below the poverty line. Although this rate is below the national rate of 14 percent, it varies considerably by county across the state, and is particularly high in Essex, Hudson and Passaic counties. Reducing poverty is a major challenge for policymakers.

The New York Fed's measures of regional credit conditions suggest continued financial challenges for families here. As of the second quarter of 2012, for those people with a credit report, average debt per person in New Jersey was about $63,000, roughly unchanged over the past several years. Delinquency rates on that debt are high: 8.4 percent of all debt in the state is seriously delinquent, up from 7.4 percent in 2011 and above the national rate of 6.7 percent. So, many New Jersey households are still struggling with their finances.

Although there are some recent signs that home prices in the state are starting to firm, nevertheless, the housing crisis continues to take a toll on our homeowners. As of June, 9.3 percent of all mortgage debt in New Jersey was 90-plus days delinquent, three percentage points above the national rate. And that delinquency rate is actually a little higher here in northern New Jersey.

National economic conditions

The performance of the U.S. economy since the end of the recession in 2009 has been disappointing. Real GDP has grown at an annual rate of just over 2 percent over this period, and it was even slower in the first half of 2012. As a result, employment gains have been modest, unemployment remains above 8 percent – an unacceptably high level – and participation in the jobs market remains depressed. Moreover, about 5 million workers have been unemployed for six months or more. This is important because long-term unemployment can cause job skills to atrophy making it more difficult for such people to find jobs in the future. While the good news is that the job-finding rates of the long-term unemployed have not yet deteriorated as many feared, we ought not to take this for granted going forward.

Although energy prices have begun to rise again, total inflation, as measured by year-over-year changes of the Consumer Price Index, is still around 1¾ percent – less than half the rate in September of 2011. In recent months, core inflation has also slowed and it is now also under 2 percent.

Higher energy and grain prices mean that headline inflation will likely edge somewhat higher for a few months before moving slightly lower again. But measures of the underlying rate of inflation are moderate, wage gains remain subdued, and longer-term inflation expectations are fully consistent with our longer run inflation objective of 2 per cent as measured by the personal consumption expenditures (PCE) deflator. Near term, the economic outlook is that the growth pace is likely to remain disappointing. On the positive side, motor vehicle sales in August increased solidly. Nevertheless, retail sales outside of autos and gasoline were soft in August as households continue to be cautious.

One brighter spot has been the housing market. Housing starts and sales of new and existing single-family homes are trending up gradually. Nationally, home prices have stabilized and begun to rise modestly after falling roughly 30 percent from their 2006 peak. Housing market conditions still vary significantly across the country with the worst performing counties experiencing annual house price declines of 8 percent or more. This sector is just getting back on its feet, so that even strong gains in the residential investment sector from its current tiny base will provide only a modest contribution to overall GDP growth. In addition, homeowner net worth remains much below its pre-crisis level.

The near-term outlook for the business sector is particularly worrisome right now. New orders for nondefense capital goods and information on business plans for spending on new structures both suggest weakness in business fixed investment. Also, many indicators point to sluggish manufacturing activity, including the ISM manufacturing composite index, several regional manufacturing surveys, and August industrial production. Our own Empire State Manufacturing Survey fell deeper into negative territory in September. This manufacturing slowdown stems from several factors, including the slowdown in the pace of growth abroad and uncertainties about how the fiscal cliff in Washington will be resolved.

So why has the economy grown so slowly since the official end of the "Great Recession?" There are many reasons, but I would cite five factors as particularly important:

- Access to credit. Although credit availability is slowly improving, it remains impaired, especially for households with less-than-sterling credit histories and for some small businesses.
- Balance sheet repair. Although substantial progress has been made, many households still need to rebuild their net worth following the housing bust. More than 20 percent of homeowners with a mortgage are "underwater" – meaning they owe more on their home than it can be sold for.
- Fiscal drag. State and local governments have been cutting spending for over two and half years and federal government spending is also contracting. While fiscal consolidation is essential over the medium to long term, spending cuts reduce demand and are a drag on near-term growth.
- Risks relating to Europe. The crisis in the euro area has reduced the demand for U.S. exports and weighed on financial markets.
- Fiscal uncertainty at home. Families and firms face elevated uncertainty relating to future taxes and government spending, in particular from the so-called "fiscal cliff" –

the prospect of sharp increases in taxes and cuts in spending at the start of 2013 if Congress and the White House cannot agree on an alternative fiscal plan.

Given the signs of improvement in some of these areas, including the slow but steady progress in healing balance sheets and restoring the supply of credit, I anticipate that the pace of economic growth will gradually pick up, supported by very low interest rates. But heading into the FOMC meeting last week, I judged that, if we did not ease monetary policy further, the pace of improvement would be unacceptably slow.

Monetary policy

Last week the FOMC took additional action to promote a more robust recovery in a context of price stability. In order to ease policy, the FOMC deployed two complementary tools: asset purchases and forward guidance on interest rates. With respect to asset purchases, the Committee said it would start buying additional mortgage-backed securities at a rate of $40 billion a month. In terms of rate guidance, the Committee said it anticipated that exceptionally low levels for the federal funds rate would likely be warranted "at least through mid-2015."

As Chairman Bernanke explained in the press conference that followed the meeting, the Committee also took two steps to underscore its commitment to ongoing support for the recovery. First, the Committee said that if it did not see substantial improvement in the outlook for the labor market, it will continue the MBS purchase program, undertake additional asset purchases and employ its other policy tools as appropriate until it does. Second, the Committee emphasized that it expects that a highly accommodative stance of monetary policy will remain appropriate for a considerable time after the economic recovery strengthens.

As usual, the Committee will publish minutes of the meeting three weeks after it took place. In the interim, however, I thought it might be useful to provide my own perspective on these actions.

In my view, the decision to ease policy further is fully consistent with our dual mandate and policy framework. As I mentioned earlier, we have two goals – to promote maximum employment and price stability. We therefore seek to minimize how far employment is from its long run normal level and inflation is from our longer-run goal of 2 percent on the PCE measure. Because monetary policy works with a time lag, we base policy not just on where the economy is today but where we expect it to be in the future. To do this, we make economic forecasts, based on data and insights from a broad range of economic models. We also take into account the balance of risks around our base case outlook.

Looking ahead, in the absence of further monetary easing, I concluded that growth would remain too subdued over the next several years to make big inroads into the spare capacity that remains from the Great Recession. As a result, unemployment would remain unacceptably high, with economic risks skewed to the downside. Meanwhile, with substantial slack in labor markets and inflation expectations stable, inflation was likely to remain a bit below our 2 per cent longer-run objective.

In this situation, I concluded that our policy framework means that further monetary policy easing was appropriate provided that the benefits of using the tools available outweighed the costs. In my judgment, this standard has been satisfied here. I am confident that the costs are manageable, based in part on the experience we have of using the tools these past four years and that the benefits substantially exceed the costs, recognizing, of course, that our actions are not so powerful that they will instantly transform the economic outlook.

So how do our actions support economic activity? Buying assets and extending interest rate guidance puts downward pressure on longer-term interest rates, so they are lower than they would otherwise be for any given economic outlook. This supports the price of assets such as equities and homes. Buying mortgage-backed securities has the additional effect of narrowing the interest rate spread between these assets and Treasuries, which further reduces mortgage rates. Moreover, to the extent that our actions are seen as supporting the recovery and providing some insurance against adverse shocks, confidence in the medium-term economic outlook should also increase, making businesses and households more willing to invest, hire and spend. If we are successful, long-term Treasury yields could actually rise as confidence in a sustainable recovery increases. At the same time, the expected returns on private assets should rise and risk premia decline. This matters because such shifts would provide support to the economic recovery.

Now it is true that some of the channels through which monetary policy affects the economy may be partially impaired at the moment. For example, because of ongoing restrictions in the supply of mortgage credit to customers with less than perfect credit records, the impact of lower mortgage rates on housing is probably less powerful than normal. While this restraint should slowly ease as house prices stabilize, the difficulties of households with lower credit scores in obtaining mortgage credit warrants ongoing attention. However, it is also worth noting other channels through which monetary policy affects economic activity are not impaired, including the impact on spending that is generated by rising wealth, declining risk premia and improving confidence.

It is important to recognize that our tools are not all-powerful – monetary policy is not a panacea for all that ails our economy. But, at the margin, firms facing lower borrowing costs for any given economic outlook will invest and hire more. People who refinance at lower rates, or see the value of their homes and 401K pension plans go up, will spend more. I believe that a nudge in the right direction will move us closer to a self-reinforcing cycle of more hiring, more spending, more growth, and more investment. This is the type of virtuous cycle that we should seek and one that is consistent with a self-sustaining and improving economy.

I believe our latest statement provides greater clarity about how we intend to use the tools we have to promote our statutory objectives. As Chairman Bernanke said at his press conference, the idea is to make it "more explicit, more transparent to the public, make it more obvious that the Fed will do what's needed to provide the support for the economy."

In particular, the amount of asset purchases that we undertake will be a function of how the economy evolves. If the economy is weaker, we'll do more. If the economy is stronger, and we see a substantial improvement in the outlook for the labor market sooner, we'll end up doing less. From my perspective, linking our purchases more closely to economic outcomes underlines our determination to generate the kind of recovery that will deliver more rapid progress toward maximum employment in the context of price stability.

So what does "substantial improvement in the outlook for the labor market" mean to me? Note that I will be focusing on the outlook, not just the current state of labor market conditions. In that context, it wouldn't be enough for me just to see the unemployment rate decline a bit. It would also matter why the unemployment rate is declining and whether that improvement is likely to be sustained in the future. For example, higher payroll growth that was not supported by stronger economic growth, or falling unemployment rates that were due mainly to declining participation in the labor market, would not likely meet my test. Therefore, to gauge how substantial the improvement in the outlook for the labor market is, I will be looking at a range of indicators, including the unemployment rate, payrolls, the participation rate, the employment to population ratio and job finding rates, as well as the growth momentum within the economy.

As we approach year-end, the maturity extension program in which we are increasing our holdings of long-dated Treasuries will be coming to an end. I'll be taking stock on how we are doing with respect to our employment and inflation goals and whether it will be appropriate to continue purchasing longer-dated Treasuries when that program concludes. I think that this will depend on whether we have seen a substantial improvement in the labor market outlook in the interim and any further evidence about the costs and benefits of continuing such purchases.

In terms of our monetary policy regime, the FOMC statement noted that the Committee expects to maintain a highly accommodative stance of monetary policy "for a considerable time after the economic recovery strengthens." This is important because in situations such as the one we find ourselves in today, when monetary policy is somewhat constrained because we cannot lower the federal funds rate below zero, one of the most powerful things a central bank can do is to provide guidance as to how it will behave in the future. In this respect, I am pleased that we have drawn a sharper distinction between what we expect the economy to look like in a few years time and how we expect to set policy based on that outlook.

In particular, when the Committee extended the period for which it anticipates keeping the federal funds rate at exceptionally low levels – which I interpret to mean the current range of zero to 25 basis points – to "at least through mid-2015," I don't think this was due to greater pessimism about the economic outlook. In fact, when you look at the September Summary of Economic Projections of the Committee members – the medium-term growth outlook was upgraded a bit relative to prior July projections. In my judgment, combining the statement and our projections, the proper inference is that we were acting to secure a better outcome – more rapid progress toward full employment and price stability.

Conclusion

To sum up, too many people remain without the jobs that they need to help support their families and themselves, and while the economic expansion is continuing, we aren't yet growing fast enough to put back to work many of the idle workers and business facilities that represent the productive potential of our economy. Meanwhile analysis of the inflation outlook suggests that price increases are likely to be close to our 2 per cent longer run objective over the coming years.

Not all of the factors that are holding back growth are directly amenable to monetary policy. Our nation's economic challenges cannot be solved and our economic fortunes restored by the Federal Reserve alone. Others – notably the next Congress and White House – will have to step up to the plate.

But I am confident that the Fed will promote maximum employment and price stability to the greatest extent our tools permit, and we will stay the course. We are setting policy to achieve a stronger recovery in the context of price stability. When that finally materializes, I'll view it as consistent with the result we are trying to achieve, and not a reason to pull back our policies prematurely. If you're trying to get a car moving that is stuck in the mud, you don't stop pushing the moment the wheels start turning – you keep pushing until the car is rolling and is clearly free.

Thank you for your kind attention. I would be happy to take a few questions.