

William C Dudley: The national and regional economy

Remarks by Mr William C Dudley, President and Chief Executive Officer of the Federal Reserve Bank of New York, at Queens College, Flushing, New York, 18 November 2013.

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Good afternoon. It is always a pleasure to speak with the different communities that make up our region, and it is especially gratifying to have the opportunity to speak with you, our future leaders. So thank you for inviting me.

I am especially pleased to be here at CUNY (City University of New York) Queens College, given the relationship that we have developed with CUNY through our educational and regional outreach. This academic year we are hosting, at the Bank, a Queens College student participating in the CUNY Service Corps which is a program to provide students with work experiences in regional and economic outreach. We also collaborated with CUNY for this year's *College Fed Challenge*, our yearly competition where teams of students from area universities take on the roles of the members of the Federal Open Market Committee (FOMC) and debate the appropriate next step for U.S. monetary policy. A number of CUNY schools competed and professors served as judges, including your own Professor Thom Thurston.

My meeting with you today is part of our continuing efforts to understand what is going on at the grassroots level of our economy and to share what we are seeing. Earlier today, I met with a number of Queens business leaders, and the leadership of HANAC, the Hellenic American Action Committee. Following this visit to Queens College, I'm headed to the Queens Chamber of Commerce to meet with others in the business community. Subsequently, I'll tour the manufacturing floor of Steinway & Sons piano factory.

The agenda for these visits is always packed, but that's part of the point – to meet with a diverse array of people in order to get a comprehensive picture of economic conditions and issues in the regions we serve and a fuller understanding of the major concerns. This is our second trip to the Borough of Queens in the past few years and recent trips have also taken us throughout our District, to Upstate New York, Northern New Jersey, Long Island, Fairfield County, Staten Island, Brooklyn and the Bronx.

These outreach trips complement the ongoing efforts of the New York Fed to assess conditions in our region, which I will discuss shortly. Among our activities, we monitor economic performance on a monthly basis, we tap into the insights of the members of our Small Business and Agriculture Advisory Council and Upstate Advisory Board, we have constructed a consumer credit panel that allows us to better understand the financial condition of homeowners and students, we have developed a “Regional Mortgage Conditions” dataset and other housing tools at the county and zip code level to ensure that policymakers and counselors are well informed, and we conduct a biannual poll of small businesses to understand their credit needs and availability. Interestingly, our most recent poll, released in May of this year, shows improvements in small businesses' ability to get credit throughout the region, though it remains a major growth challenge for these types of firms.

As you can see, we have a lot to keep us engaged with the region. Much of this information can be found on our website, which I would invite you to visit and use as a resource.

Now, I'd like to review recent developments in the local and national economies, and at the end of my talk will be happy to answer any questions you have.

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.

Regional economic conditions

Starting with the area's economy, one of the greatest challenges in the City over the past year has been the massive disruption and destruction caused by Superstorm Sandy. While areas of the New York City metropolitan region were hard hit by the storm, the devastation was particularly severe along the waterfronts of Queens – and in particular in Far Rockaway. We saw and heard about the devastation of the storm first-hand from many of those affected, through a series of support clinics that we held in the storm's immediate aftermath, as well as from many of our own employees who lived in some of the hardest hit areas.

The good news is that a little more than one-year later there has been a significant rebound in employment and economic activity across the five boroughs. New York City has continued to see pretty solid job creation through this past summer, and, in stark contrast with past economic expansions, this is happening without any direct contribution from the securities industry – or, more colloquially, Wall Street. So far this year, the city's job gains have been broad-based, led by strong growth in industries such as education and health, advertising, computer services, leisure and hospitality, wholesale and retail trade, and, especially, construction.

Of course, while it is reassuring that most of the city has bounced back strongly from this historic natural disaster, it is important to remember that the hardest hit communities, and the residents and businesses there, who lost so much, are still struggling to recover. Many of those communities are right here in Queens: the whole Rockaway peninsula – from Breezy Point to Arverne – was completely flooded, as were neighborhoods like Howard Beach, Springfield Gardens, Lindenwood, and even parts of Flushing, Long Island City, Astoria and Maspeth. Still, Queens as a whole showed strong resilience – employment bounced back from Sandy fairly quickly, and as of early 2013 it had already surpassed its pre-Sandy level.

While many residents here commute to work in other boroughs, primarily Manhattan, Queens has a formidable industrial base of its own. Jobs are prevalent in industries ranging from medical care to construction, not to mention printing and a number of other manufacturing industries that benefit from being in a large population center. But Queens' most concentrated industry is transportation – specifically air transportation which employs about 27,000 workers, about five percent of Queens' jobs.

Education is another key industry in Queens and the city as a whole. And it is not just a job creator. The investment in human capital that education entails makes it a socially desirable activity. There is considerable value from a college education both to the person that has been educated and to society as a whole. The Great Recession and sluggish recovery that has followed has made it difficult for people to find jobs, and I'm sure you may be wondering about whether going to college will turn out to be a good investment, especially if faced with the burden of student debt, something we track quite closely.

Let me reassure you, the benefits of a college degree remain significant. Research we have undertaken at the New York Fed shows that young people with a college degree are more likely to have a job and they tend to earn considerably higher wages than those without degrees – and this is true even for those who may be underemployed initially when they first enter the labor market after graduation. Although the labor market has been challenging for college graduates in recent years, I am confident that most will find work and transition into higher-skilled jobs as they gain experience and as the labor market improves.

Now, I'd like to turn my attention to recent developments in the national economy.

National economic conditions

Let me begin by taking stock of where we are at the moment. Then I will address my expectations for the performance of the economy in 2014 and 2015.

Since the end of what is now called the Great Recession in mid-2009, the U.S. economy has experienced 17 consecutive calendar quarters of positive growth of real GDP. However, the compound annual rate of growth over that period has only been around 2 ¼ percent, close to prevailing estimates of the economy's potential growth rate. Thus, we have made limited progress in closing the substantial output gap that was created during the recession.

A similar conclusion is drawn from an assessment of labor market conditions. Although the unemployment rate has declined by about 2 ¾ percentage points since peaking at 10 percent in October of 2009, a significant portion of that decline reflects the substantial decline of the labor force participation rate over that period. It should also be noted that since the previous business cycle peak at the end of 2007, the decline of the labor force participation rate has been more than accounted for by a decline in participation of people in the prime working age of 25 to 54.

The inflation data are also consistent with this overall picture of an economy operating well below its full potential. Total inflation, as measured by the personal consumption expenditures (PCE) deflator, has been quite volatile in recent years due to sharp fluctuations in energy prices. Core inflation, which excludes the volatile food and energy components and thereby may be a better guide as to underlying inflation, slowed from around 2 percent in early 2012 to just above 1 percent in mid-2013. In recent months it has shown signs of stabilizing, but remains well below the FOMC's expressed goal of 2 percent for total inflation. Fortunately, inflation expectations remain relatively stable at levels somewhat above the current inflation rate. This stability should help prevent an undesirable further drop in inflation relative to our 2 percent objective.

That said, there are some nascent signs that the economy may be doing better. For example, based on the first estimate, which is subject to revision, real (gross domestic product) GDP increased at a 2.8 percent annual rate in the third quarter of 2013, above the trend of the past four years. And the most recent payroll employment report showed a pickup in the monthly pace of job gains. The 3-month moving average rose back above a 200,000 pace after slowing to about 150,000 as of July of this year. I hope that this marks a turning point for the economy.

But before we rush to this conclusion a few more cautionary comments are appropriate. With respect to GDP growth, it turns out that inventory investment contributed ¾ of a percentage point to that overall growth rate. Thus, because this impetus from inventories will likely reverse this quarter, the real GDP growth rate is likely to slow to around a 2 percent annual rate or a bit less in the fourth quarter. With respect to payroll employment, we have seen such bursts in payroll growth before over the past few years and have been disappointed when the pickups proved temporary and did not lead to a rise in the overall growth rate.

But, I have to admit that I am getting more hopeful. Not only do we have some better data in hand, but also the fiscal drag, which has been holding the economy back, is likely to abate considerably over the next few years at the same time that the fundamental underpinnings of the economy are improving.

The first thing to note is that federal fiscal policy in 2013 has been unusually contractionary. At the beginning of the year the payroll tax cut expired while tax rates on higher income households were raised, a series of taxes associated with the Affordable Care Act took effect, and spending was reduced due to the sequester and the gradual winding down of foreign military operations. According to the Congressional Budget Office, the cyclically-adjusted or full-employment budget balance increased by roughly 1 ¾ percentage points of GDP in fiscal year 2013. Over the past 50 years there have been only two other episodes of fiscal contraction of this order of magnitude, and both of those occurred when the unemployment rate was substantially lower than it has been of late. Under current law, the amount of federal fiscal restraint will decline in 2014 and then decline further in 2015. At the same time, the sustained contraction in spending and employment by state and local governments appears to be over.

The fact that the U.S. economy has continued to grow at around a 2 percent pace in 2013 despite this quite intense fiscal restraint provides evidence to the second key point, which is that the private sector of the economy has largely completed its healing process and is now poised to ramp up its level of activity. Key measures of household leverage have declined and are now near the lowest levels they have been in well over a decade. Household net worth, expressed as a percent of disposable income, has increased back to its average of the previous decade, reflecting rising equity and home prices and declining debt. Recently, banks have eased credit standards somewhat after a prolonged period of tightness. As a result, we are now experiencing a fairly typical cyclical recovery of consumer spending on durable goods. For example, sales of light-weight motor vehicles have increased steadily over the past four years, reaching an annual rate of 15.7 million in the third quarter of 2013, though sales in September and October have been somewhat below that average.

Similarly, after five years in which housing production was well below what is consistent with underlying demographic trends and the replacement demand for houses, it now appears that we have worked off the excess supply of housing built up during the boom years of the last decade. Housing market activity has begun to recover, and a widely followed national home price index is up 12 percent over the 12 months ending in September.¹ Anecdotal reports suggest that this higher-than-expected increase in home prices is due to a relatively low number of homes for sale. Due to this shortness of supply, there is reason to expect increases in starts going forward.

Yet another bright spot on the horizon is the fact that growth prospects among our major trading partners have improved following a few years of lackluster performance which induced a sharp slowing of growth of U.S. exports. In particular, the euro area appears to have emerged from a protracted recession and is experiencing modest but positive growth.

To summarize, while growth in 2013 has been disappointing, I believe a good case can be made that the pace of growth will pick up some in 2014 and then somewhat more in 2015. The private sector of the economy should continue to heal, while the amount of fiscal drag should subside. Despite near-term concerns, growth prospects among our major trading partners will improve further next year. This combination of events is likely to create an environment in which business investment spending will strengthen. As growth picks up, I expect to see more substantial improvement in labor market conditions and a gradual updrift in inflation back towards the FOMC's target rate.

However, the notion that the economy will grow more swiftly remains a forecast rather than a reality at this point. As is always the case, there is substantial uncertainty surrounding this forecast. Moreover, there is always the possibility of some unforeseen shock. Thus, we will continue to monitor U.S. and global economic conditions very carefully and will adjust our views on the likely path for growth, inflation and the unemployment rate accordingly.

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

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