

SPEECH

The National and Regional Economic Outlook

April 13, 2012

[William C. Dudley](#), President and Chief Executive Officer

Remarks at the Buffalo-Niagara Partnership, Buffalo, New York

As prepared for delivery

Good morning, I am pleased to be here in Buffalo to address the Buffalo-Niagara Partnership. It is always a pleasure to speak with the business community because of the leadership role you play in the economy of the region. I thank you all for inviting me here today.

I try to get out of my office in New York City as much as I can to get a sense of regional economic conditions across the second Federal Reserve District. I was last here in Buffalo in 2010 and, more recently, I traveled to West Point and the Capital region and Long Island.

These visits are just as important as any trip I might take to Washington, D.C., to help formulate monetary policy, or to Switzerland, to help shape international bank regulation. Each visit within the region helps me to deepen the relationships with the people I represent. I believe that the understanding of issues and concerns that I gain today will help ensure that the Fed's policy decisions reflect the public interest.

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 economic outlook nationally and locally. 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 on behalf of the Second District.

I have the great fortune to serve as vice chair of the FOMC 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 set policy to advance the mandate given to us by Congress to promote the maximum level of employment consistent with price stability. Sometimes we have different views on the specific policy choice 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 and in our belief that Fed independence is essential to the public interest. That independence allows us to make tough decisions insulated from short-term political pressures.

At FOMC meetings, each Committee member presents a current outlook for his or her region and the nation. For these assessments, we consult our researchers and add critical information that we learn from listening to our boards of directors, regional advisory councils and community leaders, such as you and others I'll meet on this visit. For example, last month members of our small business advisory council told us that for the first time in several years, employees were leaving for other jobs and that they would need to replace those who left for better opportunities elsewhere. The fact that some people with jobs felt confident enough to seek and take other job opportunities was another signal to us that the job market may be improving—although, to be sure, we read such signals cautiously.

To help me gather more information about the region, yesterday, I had breakfast in Syracuse with business and community leaders at the Center for Economic Development. Then I met with the staff of PathStone, a community development organization, met faculty and students at the Maxwell School of Syracuse University and had lunch with university officials who manage the tech transfer process. In the afternoon, we drove to Skaneateles Falls to tour Welch Allyn, a manufacturer of medical diagnostic instruments. Dr. Julie Shimer is the president and CEO. Dr. Shimer was also recently appointed chair of the Empire State Development Corporation, and we talked about challenges and opportunities for economic development in New York State.

After this morning's gathering, I will speak with staff of the Empire Justice Center, meet with Lt. Governor Bob Duffy, convene a meeting of our Upstate Advisory Board, whose members are major leaders in the upstate economy, and visit the Roswell Park Cancer Institute to learn about their role in economic development in western New York and in the broader world arena.

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 monthly indexes of economic activity for New York City, the state of New York and New Jersey. These indexes are essentially measures of local output—similar to gross domestic product, or GDP, at the national level. These measures provide a more complete gauge of activity than the employment report, which is another important metric at the state level. We have also constructed a consumer credit panel to track local household credit conditions at the county and even the zip code level, including the amount and type of personal debt and whether payments are being made in a timely way.

In addition, we conduct a periodic poll about the credit needs of small businesses, which are an important source of new jobs. We are just launching our latest poll that also includes questions about the skill needs of small businesses and whether the right kinds of skilled labor are available. Almost 900 regional businesses responded to our last poll, some of which were from this region. If you, as a representative of a small business, would like to participate in our current 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.

Results from prior polls stressed the problem of access to capital. In response we held two workshops at the Bank last December. In the first workshop, senior officers from the Export-Import Bank, the Small Business Administration and the Department of Commerce described the various loan programs available to small businesses from their agencies, as well as programs to help identify markets. The second workshop reviewed the business plans of 40 small businesses and then matched them with potential lenders. We plan to hold a similar workshop in Upstate New York this year.

As you know, even states that are wealthier, such as New York, 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, although much remains to be done. We have provided housing advocates with the latest information on mortgage conditions, via mortgage briefs, roundtables, presentations and newsletters. We have now developed an interactive online tool that shows monthly delinquency and foreclosure conditions, which we believe will aid the work of housing counselors and other parties seeking to help these communities. It is available on our website along with other data and information useful to policymakers, business people and the general public.

We use our website to share what we learn about our diverse District, and you will find detailed information about the region at the site. I invite you to visit newyorkfed.org to explore our highly localized maps and information on small business, credit and housing conditions and even the latest job openings at the New York Fed.

Finally, and crucially, in the aftermath of the financial crisis, we are working with our colleagues in Washington, D.C., and at other agencies to help put the nation's financial system on a firmer footing. Our supervisors are working hard to ensure that our District's banks are operating safely and soundly. Although much has been done, we are not finished and are determined to keep at it. I recognize fully that there can be no return to pre-crisis business as usual—whether on the part of the financial sector or on the part of regulators like ourselves.

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

National Economic Conditions

Now I'd like to turn to the national and regional economy. The incoming data on the U.S. economy generally has been a bit more upbeat over the past few months, suggesting that the recovery may be finally establishing a somewhat firmer footing. Real GDP expanded at a 3.0 percent annual rate in the fourth quarter of 2011, the fastest growth since the first half of 2010. The average monthly job gain was 212,000 in the first quarter of 2012, up from 164,000 in the fourth quarter. Sales of light-weight motor vehicles were about 14 ½ million at an annual rate in the first quarter, the best quarter for vehicle sales in four years. Survey measures of business activity have rebounded from their dips in the middle of last year, and are now at levels that typically indicate solid overall growth. Even housing starts have firmed somewhat in the last few months, although they remain at depressed levels.

While these developments are certainly encouraging, it is still too soon to conclude that we are out of the woods. To begin with, the economic data looked brighter at this point in 2010 and again in 2011, only to fade later in those years.

Moreover, the United States experienced unusually mild weather over the first quarter, with the number of heating degree days

more than 20 percent below the average of the preceding five years, which may have pulled forward some economic activity and hiring.

In this regard, the somewhat softer March labor market report that was released last Friday may reflect the earlier positive influence of the mild weather on job creation in January and February, although other less sanguine interpretations are also plausible. We thus will need to see more data to determine the extent to which the March data represent a transitory weather-related setback.

Regardless of the importance of the mild winter in distorting the economic data, real economic activity has yet to be strong enough on a sustained basis to make a big dent in the overall amount of slack in the U.S. economy. While growth was stronger in the fourth quarter, most of it was due to inventory accumulation. Growth of final sales remained quite weak. Historically, quarters in which inventory investment makes significant growth contributions are typically followed by quarters in which that growth contribution is modest or even negative. That appears to be what is shaping up for the first quarter of this year.

Based on available data, our current expectations are that real GDP will expand at around a 2 ¼ percent annual rate during the first quarter of 2012. Even with the robust increase of light vehicle sales, overall consumer spending in the first quarter appears to be rising at a similar moderate rate. At the same time, real disposable income has been flat over the past three months, and the large increase of gasoline prices is likely further sapping consumers' real purchasing power. And growth of business investment spending, which softened in the fourth quarter of 2011, may have been even a little softer in the first quarter of this year.

To put the recent pace of growth into perspective, we believe that the economy's long-run sustainable growth rate—what economists call the potential growth rate—is around a 2 ¼ percent annual rate. We need sustained growth above that rate to absorb the still substantial amount of unused productive capacity. Thus, our recent growth rates are barely keeping up with our potential.

Even though the unemployment rate has declined sharply from 9 percent last September to 8.2 percent in March, it is still unacceptably high. In addition, many other measures of the labor market remain weak. The labor force participation rate, the percentage of people employed, and the total number of hours worked in the economy all dropped sharply during the recession and remain well below their pre-recession levels, even taking into account the impact of demographic shifts. Also, it appears that productivity growth has slumped recently. Although that means that a given amount of growth translates into bigger employment gains, it certainly is not an unmitigated positive development.

Also, we cannot lose sight of the fact that the economy still faces significant headwinds and that there are some meaningful downside risks. In the headwinds department, I would include the run-up in gasoline prices mentioned earlier because that will sap purchasing power, the continued impediments to a strong recovery from ongoing weakness in the housing sector, and fiscal drag at the federal and state and local levels. In terms of downside risks, these include the risk that growth abroad disappoints and the risk of further disruptions to the supply of oil and higher oil prices.

On the inflation front, the overall rate of increase of consumer prices, as measured by the 12-month change of the price index for personal consumption expenditures, slowed to 2.3 percent in February from a recent peak of 2.9 percent last September. Even though the recent rise of gasoline prices mentioned above could interrupt this pattern, we expect this moderation of overall inflation to resume later this year.

While the underlying core inflation rate, that strips out volatile food and energy prices, has been somewhat higher than expected a few months back, it appears that the annual rate of core inflation¹ has peaked and we expect it to begin to decline later this year.² Finally, inflation expectations, which play an important role in the inflation process, remain well anchored. By this I mean that people expect that the rate of inflation will continue to be relatively low for some time to come.

Regional Economic Conditions

So how is the recovery proceeding in the state and the region? As I mentioned, the New York Fed produces indexes that help us track economic activity in the region. Based on these measures, the economic recovery that began in New York State in late 2009 has continued through early 2012, and even gained some momentum.

Across Upstate New York, the cycle of recession and recovery has been much less pronounced than in the nation, which means that the region has been more stable in recent years than many other places around the country. This has been particularly true in Buffalo, which experienced an employment decline of about 3½ percent during the downturn—a significant loss, to be sure—but well below the over 6 percent decline that occurred nationally.

One reason why Upstate New York weathered the storm better than the nation as a whole is the resiliency of its housing markets. Like much of Upstate New York, Buffalo's housing market has proven to be more stable than many other parts of the country. In fact, since the peak of the national housing market in early 2006, home prices in the Buffalo area have increased by about 10 percent, compared with a decline of more than 30 percent nationally. As a result, the drop-off in economic activity that is connected, directly and indirectly, to the performance of the housing sector has not been as severe here as in many other places

around the country.

This stability is underscored by our latest quarterly consumer credit panel data, which shows that total household debt burdens have remained relatively low by national standards and that mortgage delinquency rates are lower in the Buffalo area than in other parts of the state and nation.

The recovery is proceeding in Buffalo, slowly but surely. So far, the region has gained back nearly 12,000 of the roughly 20,000 jobs it lost during the downturn. This is somewhat faster progress than the nation has made, although, in part, that's because the downturn was less severe here.

One particularly good bit of news is that for the first time in decades, manufacturing has been a source of job growth in the region, rather than decline, adding more than 3,000 jobs over the past few years. That's nearly twice the pace of growth of the U.S. manufacturing sector.

That said, it is somewhat worrying that the pace of the recovery locally has actually slowed in recent months just as the national recovery has started to gain some momentum. Despite this recent slowdown, I believe there are reasons to be optimistic about Buffalo's longer-term outlook. In particular, the decades long economic restructuring that has occurred in the region has resulted in a more diversified economy. While the region still maintains a strong manufacturing presence, it is no longer the main source of jobs in the area. In its place, the health and education sectors have emerged as important sources of job opportunity and economic development potential. These sectors have provided stability to the region through the recession and recovery.

The recent announcement of Governor Cuomo's \$1 billion economic development pledge to the region is another positive development. This commitment represents a tremendous opportunity for the region to accelerate the economic transformation already underway. Therefore, it is important for the community to think strategically about how best to use these funds to leverage the region's existing strengths.

Buffalo's colleges and universities deserve special attention within this strategy. Not only do these institutions produce highly skilled labor, they also promote innovation by creating new knowledge and inventions through academic research and development. It can be especially beneficial for local businesses to take advantage of both the knowledge created and the availability of research facilities at local colleges and universities.

Partnerships between private industry and higher-education institutions are an important ingredient in this regard. Going forward, I believe these partnerships will become more important than ever—particularly for places like Buffalo that continue to undergo economic restructuring. Fortunately, the region has a strong higher education sector in place.

Conclusion

To sum up, the incoming data on the U.S. economy has been a bit more upbeat of late, suggesting that the recovery may be getting better established. But, while these developments are certainly encouraging, it is far too soon to conclude that we are out of the woods in terms of generating a strong, sustainable recovery. On the inflation front, the year-over-year rate of consumer price inflation has slowed in recent months, and despite the recent rise of gasoline prices, we expect inflation to moderate further in 2012.

Here in Buffalo, the economic restructuring has positioned the region's health and education sector as a potentially solid base for longer-term growth.

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

¹ As measured by the 12-month change in core PCE deflator.

² See for instance, the behavior of the three- and six-month changes in the core PCE deflator.
