SPEECH

The National and Regional Economy

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Good morning, I am pleased to be at Pace University to address the university community of students, alumni, faculty and university supporters. It is always a pleasure to speak with academic audiences who I find to be particularly well-informed and attentive. I thank you for inviting me here today. In a timely note, I also want to commend Pace University for fielding an excellent Fed Challenge team this year. As many of you know, Pace won the Second District College Fed Challenge this year and has just returned with an honorable mention from competing in the nationals at the Board of Governors in Washington, D.C.

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 and monetary policy.

In covering the region and the nation, I will discuss the terrible impact of Sandy on the region and the implications for the national economy. I know I will fall short in fully acknowledging all the hardship that our fellow citizens have endured—including devastating losses of loved ones, homes, communities and livelihoods—as well as widespread misery caused by flooding and disruptions to power, fuel, food, transportation and other services across the region. Nor will I be able to fully commend the ways in which family members, neighbors, co-workers and strangers have helped those in need. I am deeply moved by the evidence of people reaching out and pulling together across the region.

At the New York Fed we are committed to supporting the recovery process. In addition to our economic analysis, we are convening our advisory groups and other regional contacts to receive first-hand accounts of the impact on communities, families and businesses and to assess other ways in which we may help. For example, we are holding a clinic in Staten Island to help people obtain information about different types of financial support that is available. We're also encouraging banks to show appropriate flexibility when dealing with small business and other borrowers impacted by the storm.

After my remarks, I'll be happy to answer any questions you have about what the Fed does and why, and about the economic outlook. But I won't comment specifically on the upcoming FOMC meeting next month.

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 our 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 some people call the financial system's "plumbing." For example, we help ensure that banks' ATMs have cash and that the checks you write move the money to the recipient. In addition, 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 decisions about monetary policy. The members of this committee all strive to achieve our statutory mandate of full employment and price stability. Sometimes we have different views on the specific policy choices at hand, and our policy decisions reflect a full discussion of these differences. This diversity of viewpoints is a key strength of the FOMC.

In fact, I believe 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 considerations.

At FOMC meetings, each Committee member presents a current outlook for his or her District 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 today is part of this systematic effort to understand what is going on at the grassroots level of our economy.

To add to what I learn from my conversations, my colleagues and I at the New York Fed continually track conditions in our District, and we have created special tools for that purpose. For example, my staff tracks local household credit conditions, including the amount and type of personal debt and whether repayments are timely.

We also conduct a periodic poll about the credit needs of small businesses, which are an important source of new jobs in the District. If you represent a small business and 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.

To promote growth in our local communities, we publish extensive data and analysis on the local economy. We provide outreach initiatives, including workshops on access to global markets and to help small businesses learn about loan programs and sources of credit enhancements. We also run an annual video festival for local college and university students. In this program student teams produce videos that aim to help young adults make sound personal financial decisions. A panel of advertising and video professionals selects winning video productions for screening in local movie theaters.

As you know, even regions as wealthy as ours 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 fall we hosted a conference on distressed residential real estate to share new expert analysis with senior policymakers and practitioners from across the nation. Later today, colleagues from our Research department will provide a press briefing on the housing outlook in our region as a whole. Next week, we will be holding a workshop so we can better understand the factors that are limiting the pass-through of lower yields on agency mortgage bonds into primary mortgage rates offered to borrowers. We will then be in a better position to evaluate what steps if any might be taken by the relevant authorities to contribute to greater pass-through.

Regional Economic Conditions

Our region's economy was on a moderate upward trajectory before Sandy struck, and while the storm had many severe effects—more on that in a few minutes—I do not expect it to derail the region's ongoing economic expansion.

New York City's economy has been performing quite well. Employment in the city reached an all-time high at the beginning of this year and it has continued to grow briskly since then, even without help from its key finance sector. While job growth has been considerably more subdued in the surrounding areas, such as Long Island, northern New Jersey, Fairfield County and the lower Hudson Valley, many workers in these areas commute to New York City for their jobs, so the strength here in the city is helpful to the region as a whole. Still, the unemployment rate in the city remains high, above 9 percent, and this is something that needs to improve. Upstate New York's economy is also on a generally positive trajectory, although some areas have fared better than others. Albany, Buffalo, and especially, Rochester and Ithaca have recouped many of the jobs lost during the recession, whereas Syracuse and Binghamton have lagged.

Looking beyond the employment statistics, I see other encouraging signs across the region. Housing markets here have improved. There has also been a noticeable pickup in multi-family construction in both New York and New Jersey this year.

However, the New York Fed's measures of regional credit conditions suggest continued financial challenges for families here. Data that we just released for the third quarter of 2012 show that for those individuals with a credit report, average debt per person in New Jersey was about $61,000, and about $49,000 in the state of New York. Overall debt per person peaked in 2008. Although balances nationally have fallen by over 11 percent, consumers in New York and New Jersey have brought down their indebtedness more moderately, by 5 percent and 6 percent respectively.

While the overall delinquency rates are decreasing nationally, delinquent balances in our region have remained stable or even increased a bit. In both New York and New Jersey, nearly 9 percent of balances are 90 or more days delinquent, higher than the 6.5 percent national rate.

Although there are some recent signs that home prices are starting to firm, the housing crisis continues to take a toll on our homeowners. Delinquency rates on mortgages, at 9.4 percent and 9.7 percent in New York and New Jersey, respectively, remain considerably higher than the 5.9 percent national rate.

Before discussing the national outlook let me talk briefly about the possible effects of "Superstorm Sandy" on the U.S. and regional economy. The damage and disruptions from the storm appear more extensive and longer-lasting than first anticipated.

Of course, there is the physical damage, which was geographically widespread, but particularly devastating in some communities right here in New York City, including Breezy Point, the Rockaways, and portions of Staten Island, and in so many cities and towns along the Long Island, New Jersey and Connecticut waterfronts, such as Long Beach, Seaside Heights, Spring Lake and Hoboken.

Estimates of the costs of disruption to economic activity—that is, services that couldn't be rendered and goods that couldn't be produced because of protracted transit shutdowns, power outages and other such damage produced by the storm—are particularly difficult to pin down. Thus, it will be some time before concrete figures are available. However, the early read from recently-released data confirm these disruptions have been widespread. Every one of the New York City area firms that responded to our recent Empire State Manufacturing Survey—fielded one to two weeks after the storm—indicated that the storm disrupted activity at their firm, and 40 percent of them indicated that they were completely shut down or severely crippled for at least five days. Furthermore, the number of workers filing initial claims for unemployment insurance in both New York and New Jersey surged to more than triple their pre-storm levels in the week after Sandy hit, suggesting at least 70,000 storm-related job losses in these two states thus far.

These data suggest that the disruptions that we have seen, and continue to see, could be substantial. We can quantify the losses in terms of days of lost output. Given the regional GDP of $1.4 trillion, a rough calculation yields a loss of $3.8 billion for each full-day equivalent of lost output in the region.

A considerable part of this lost activity will be offset over time or be replaced by a temporary shift of activity from hard-hit areas to less-affected places. But, in a services-based economy, much activity cannot be shifted in time: restaurants, for instance, can't serve six meals a day to make up for lost business. The fact that many people who would have dined in lower Manhattan in the weeks following Sandy are instead patronizing restaurants near their homes or near temporary work sites represents an offset for the regional economy as a whole. But that's little consolation for the original restaurant, which may in turn need to lay off some of its people or could even possibly go out of business. And, of course, this applies even more dramatically to businesses in hard-hit places along the regional shoreline.

Against this, reconstruction began soon after the storm was over and has likely intensified since then. The repair and replacement of damaged or destroyed infrastructure, homes, and businesses is likely to continue for some time. Programs will need to be well designed in order to achieve maximum beneficial impact. For instance, on the housing front, it will be important to ensure that program design and funding recognize that our region has a wide variety of housing types—including multifamily and public housing—that are in need of repair post-Sandy. In other words, one-size-fits-all solutions may not work well here.

Past studies suggest that reconstruction spending provides a powerful stimulus to local economies, both in its direct effects and its associated multiplier effects. Thus, I expect that reconstruction will provide a similar sizeable boost to our regional economic activity, and one that is likely to continue well into 2013.

All this analysis must be viewed as early and provisional. Putting all the factors together, at present I expect that economic activity in our region was adversely affected in October and November, but will show a noticeable rebound starting in December.

In addition to the economic costs in terms of lost activity there are, of course, the costs in terms of human suffering to the millions of people who were adversely affected—above all those who lost homes and loved ones, but also the many others who were cold and without power for days on end, spent hours getting to and from work, waited on long gas lines, and experienced the stress of not knowing what lies ahead.

We are also tracking the impact of Sandy on schools and students. In New Jersey, 60 percent of schools were closed more than one and a half weeks. The storm shut down all New York City schools for a full week, and many schools across the region remained closed the following week. Hardships borne by students and families are also reflected in record low post-storm attendance rates. The New York City Department of Education moved quickly to relocate schools from damaged buildings to temporary premises, enabling children to resume their studies. But even two weeks after the storm, schools that had to be relocated had attendance rates below 70 percent, a huge drop from their regular rates of over 90 percent. Research shows that lost school days and relocations can significantly impair student learning.

The good news is that the situation is getting closer to normal every day. Today, only 9 out of a total of 1,750 New York City schools remain relocated. Also of particular importance is that their leaders—administrators, teachers, principals and others—have agreed to make up three and a half days of the lost time. It is impressive that so many districts across the region are working hard to make up for much of the lost time.

Our region must learn the right lessons from this experience. The storm revealed significant shortcomings in the resilience of our public and private infrastructures in three critical areas: power, transport and communications. This vulnerability must be addressed.

National Economic Conditions

Turning to the storm's effects on the national economy, I expect a modest negative effect on the annualized growth rate of real GDP for the fourth quarter of 2012. It is impossible to calibrate this precisely at this juncture, but I would guess this would be in the region of 0.25 to 0.50 of a percentage point. It is important to note that the storm affected much of the Northeast Corridor, a densely populated area responsible for about 15 percent of GDP. Normal economic activity in the final days of October and the first few days of November was severely disrupted. The disruption then began to subside, but only recently has life begun to feel normal again. The negative effects of this disruption have already been noted in economic indicators such as industrial production for the

month of October and initial claims for unemployment insurance during the second and third weeks of November.

Yet, some of the economic disruption experienced here was offset to some extent by stronger than normal activity elsewhere. For example, plants in Ohio or South Carolina making portable generators may have worked overtime to fill the increased demand. Second, some types of disrupted activity, such as the purchase of a car or a housing start, can be made up before the fourth quarter is over. Lastly, as I mentioned before, repair and replacement of damaged property is already underway, offsetting some of the earlier disruption. This rebuilding will continue well into 2013, likely providing for somewhat stronger growth than otherwise would have been the case. Indeed, economic studies of disasters in the U.S. and other advanced economies find that the longer-term effects on national economies have typically been negligible. Given the resilience of the U.S. economy, I expect the long-run effects of Sandy to be similarly small.

Even before the storm, though, the pace of U.S. economic growth was disappointing—averaging only slightly above a 2 percent annualized growth since the recovery began in mid-2009. As a consequence, the national unemployment rate remains unacceptably high, and its decline during the recovery has been grudging. In addition, too many people are discouraged from looking for work. This has depressed the participation rate and held down the official unemployment rate. Moreover, 5 million workers have been unemployed for six months or more. While job growth has picked up some recently, its pace has been insufficient to materially change the labor market picture.

In terms of activity, there are a few bright spots. For example, the growth rate of consumer spending was a bit firmer in the third quarter. Another area showing improvement is the housing market. Housing starts and sales of new and existing single-family homes are trending up gradually. Nationally, home prices have finally begun to rise.

However, on a more negative note, business fixed investment spending fell some in the third quarter and new orders for nondefense capital goods suggest continued softness. Overall, manufacturing activity remains weak. This manufacturing slump stems from slower growth abroad and uncertainties about how the fiscal cliff in Washington will be resolved.

On the inflation side of ledger, despite sharp rises in energy prices in recent months, overall inflation, as measured by year-over-year changes of the consumer price index, is still around 2 percent—significantly lower than last year. The signals from underlying inflation pressures, compensation trends, and longer-term inflation expectations are all fully consistent with our longer-run inflation objective of 2 percent.

As you all know, in September, the FOMC took additional action to promote a more robust recovery in a context of price stability—a decision that was reaffirmed in October. In addition to the $45 billion monthly purchases of longer term Treasury securities already scheduled to run through year end, the FOMC commenced buying additional mortgage-backed securities at a rate of $40 billion a month. The Committee said: "If the outlook for the labor market does not improve substantially, the Committee will continue its purchases of agency mortgage-backed securities, undertake additional asset purchases, and employ its other policy tools as appropriate until such improvement is achieved in a context of price stability.[1]

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"—emphasizing that a highly accommodative stance of monetary policy would remain appropriate for a considerable time after the pace of the economic recovery strengthens.

So, what does "substantial improvement in the outlook for the labor market" mean to me? A key point is that I will focus on the labor market outlook, not just its current state. Therefore, I will be looking at the growth momentum within the overall economy and a range of labor indicators, including the unemployment rate, payrolls, the participation rate, the employment to population ratio and job finding rates. Following the framework we set out in September, I will be assessing the employment and inflation outlook in order to determine whether we should continue Treasury purchases into 2013.

We will continue to do our part to push the economy towards maximum sustainable employment in the context of price stability. Yet, it is important to recognize that our tools are not all-powerful—monetary policy is not a panacea for all that ails our economy.

In particular, Congress and the administration must address the "fiscal cliff" in a manner that creates a credible framework for long- term fiscal sustainability. It is widely acknowledged that the large fiscal contraction associated with going "off the cliff" would drive the U.S. economy into recession. The contractionary impact is likely to be larger than normal when monetary policy is operating at the zero lower bound for interest rates, as is the case today. Thus, fiscal consolidation must be accomplished in a way that avoids derailing the economic recovery. The best way to do this is to craft a plan that starts small in terms of its near-term impact, then grows very substantially over time as the economy grows healthier. Of course this requires that the longer-term consolidation is truly credible. It is also important that any plan have broad bipartisan support so that that households and businesses understand that it will in fact be carried out.

We saw in the summer of 2011 when the debt ceiling limit was in play that a failure to come to grips with our nation's economic challenges and responsibilities can have a large effect on U.S. household and business confidence. We do not want to repeat this experience at the start of 2013.

Moreover, what happens will influence how we are perceived abroad. When I meet with economic leaders across the globe they do

not doubt the underlying strength and dynamism of the U.S. economy, or the entrepreneurialism and inventiveness of our people. Nor do they doubt that we have the resources and capability to overcome the challenges we face. But they do wonder whether our political system is capable of putting the national interest above partisan interests and making the tough choices needed to address these challenges.

If a credible bipartisan agreement is reached, it will strengthen global confidence in the U.S. and underscore to the world that our country remains a great place to do business and invest in. Failure would suggest a degree of political dysfunction that could undermine U.S. economic leadership and could encourage global corporations and investors to invest elsewhere.

Make no mistake: Credible fiscal consolidation will not be painless, no matter what form it takes. The burden will be felt across many sectors of the economy and we must expect that the resulting fiscal drag will exert some restraint on economic growth.

Nevertheless, there is no reason why a carefully crafted plan would need to put the economic recovery at risk. A credible plan, after all, would likely have very positive effects on confidence. In particular, I believe that business investment would respond positively to a credible plan. More generally, reducing uncertainty over future tax rates, entitlements and other spending programs has to be a positive development in terms of reducing uncertainty that can constrain economic activity. By clarifying the rules of the road, a credible fiscal plan is likely to reduce the incentive of households and businesses to delay spending and investment. This would likely offset fiscal drag to a meaningful degree.

Conclusion

To sum up, while it is still too early for a precise estimate of the economic impact of Sandy, I expect a negative impact on fourth quarter national and regional economic growth, but a minimal long run effect nationally and regionally. This has happened during a period where too many people remain without the jobs that they need to help support their families and themselves. Although the economy continues to expand, we must grow faster if we are to put all of our jobless workers and idle businesses back to work. Meanwhile, price increases are likely to be at or slightly below our 2 percent longer-run objective over the next few years.

Many parts of our region were showing a stronger pace of growth than the country as a whole before the storms hit—and I am hopeful that Sandy will not have pushed us off this trajectory for long. The recovery of housing markets are important part of this renewed growth, although certain communities are still weighed down by lingering high rates of delinquencies and foreclosures and some others have suffered appalling damage from Sandy.

Going forward, let me reiterate that the Fed will promote maximum employment and price stability to the greatest extent our tools permit, and we will stay the course. When we achieve a stronger recovery in the context of price stability, I'll view it as consistent with our goals and not a reason to pull back on 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.

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[1] September 12-13, 2012 Federal Open Market Committee statement. OFFSITE