William C Dudley: The challenges ahead

Remarks by Mr William C Dudley, President and Chief Executive Officer of the Federal Reserve Bank of New York, at the Center for the New Economy 2010 Economic Conference, San Juan, Puerto Rico, 19 February 2010.

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Thank you very much and good morning. Although this is my first visit to Puerto Rico in my current role, I have been here a number of times, going way back to a childhood visit with my parents. It's a beautiful and special place, but I must admit that coming in February has some special advantages.

I welcome this opportunity to talk with business leaders, workers and educators. My goals are to hear what issues are on the minds of people here and to let you know what the Federal Reserve has been doing to help improve the economy. So I'm very grateful to the Center for the New Economy (CNE) for giving me the opportunity to speak to – and learn from – you. As always, what I have to say reflects my own views and not necessarily those of the Federal Open Market Committee or the Federal Reserve System.

I want to start by talking about the implications of the close economic ties between the mainland and Puerto Rico. Since the economies of the mainland and the Commonwealth are very tightly linked, what happens on the mainland has important consequences for Puerto Rico, as well. In the aftermath of the financial crisis, we anticipate that the mainland recovery will prove to be sustainable, and that this will ultimately benefit the economy here. But Puerto Rico faces some significant challenges beyond its ties to the weaknesses in the broader U.S. economy, including problems in its own financial sector. Dealing with these problems forcefully and expeditiously is crucial to ensuring that Puerto Rico benefits fully from the expected economic recovery over the next few years. The Fed is assisting in several ways: by setting the stage for a resumption of world economic growth, by helping to resolve problems in the U.S. mainland and Commonwealth financial sectors and by partnering with Puerto Rican groups to make meaningful contributions toward resolving some of the Commonwealth's other underlying issues.

Puerto Rico's special economic relationship with the mainland

Puerto Rico has what economists often call an "open economy." What this means is that Puerto Rico is especially dependent on external trade, so what happens to the Puerto Rican economy is greatly affected by what is going on with its major trading partners. When demand from Puerto Rico's export customers is weak, then sales and prices for the Commonwealth's products fall, so jobs and incomes on the island suffer.

In the recent recession – as in many financial crises – global trade declined even faster than output. As a result, the shock generated by the financial crisis spread quickly throughout the world. Economies and regions far from where the problems began suffered. This was especially true for economies dependent on trade, such as Puerto Rico's. In fact, Puerto Rico suffered much more than most because the Puerto Rican economy was already in recession when the financial crisis struck.

While Puerto Rico interacts with many other economies, one partner looms especially large for the Commonwealth. For generations, the mainland United States and Puerto Rico have had a special economic relationship in many dimensions. One of the most obvious of these ties is the free flow of people between the mainland and the island. Indeed, according to the U.S. Census, about one half of the people who identify their origin as Puerto Rican lived on the mainland in 2008. The active migration, return migration and remittances to family members reflect and reinforce the close personal and economic ties between Puerto Rico and the mainland.

Another link is our common use of the dollar. This means that tourists from the mainland can visit without worrying about changing currencies. In addition, businesses can make long-term investments in Puerto Rico without worrying that currency fluctuations against the dollar will undermine their competitiveness. It also means that when the U.S. dollar falls in value, Puerto Rico's exports become more competitive around the world, although not, of course, in the United States.

Somewhat less obvious are the consequences of the mainland's role as Puerto Rico's largest trading partner. The mainland accounts for half of the island's imports and three-quarters of its exports. With such heavy trade flows, when the mainland economy does poorly – as during the past year – Puerto Rico's economy and job growth suffer.

Financial regulation also represents an important linkage. Of course, my presence here representing the New York Fed is one example of that particular connection – Puerto Rico is part of the Second District of the Federal Reserve System, along with New York, the U.S. Virgin Islands and parts of New Jersey and Connecticut. I'll return to the theme of financial regulation shortly. For now, let me just say that we share, along with the rest of the world, a commitment to taking the necessary steps to prevent the type of financial crisis that we just experienced from recurring in the future.

The Fed's role in coping with the crisis and the outlook for the United States

The close ties with the mainland means that the broader outlook for the United States is very important for Puerto Rico. The U.S. economy has been through a terrible period, having suffered the worst financial crisis in 70 years. Extensive study of banking crises shows that they tend to be "protracted affairs" with surprisingly similar, if unpleasant, contours. Downturns average four years, during which the unemployment rate rises an average of 7 percentage points. The peak-to-trough decline in output averages 9 percent.

Those statistics point out the risks that we faced. Well aware of the threat of a second Great Depression, U.S. policymakers took very aggressive actions to support economic growth in 2008 and 2009. The Fed provided liquidity facilities and took many other actions to contain and reduce pressures in financial markets, while the U.S. Treasury supported the banking system and provided cash and incentives to households, businesses, and state and local governments to support spending during 2009.

The Fed's "lender of last resort" interventions – including facilities such as the Term Securities Lending Facility (TSLF) and the Primary Dealer Credit Facility (PDCF), as well as programs such as reciprocal currency agreements – are examples of the rapid application of central banking tenets to the unique challenges we faced as this crisis evolved. Indeed, in many ways, the crisis has underscored why the Federal Reserve was created almost a century ago: to provide a backstop for a banking system prone to runs and financial panics.

Where it proved necessary and feasible, the Fed also used its emergency lending authority to forestall the disorderly failure of systemically important institutions. These actions truly were extraordinary – well outside the scope of our normal operations – but our judgment was that not taking those actions would have risked a broader collapse of the financial system and a significantly deeper and more protracted recession. Faced with the choice between these otherwise unpalatable actions and a broader systemic collapse, the Fed, with the full support of the Treasury, invoked its emergency lending authority and prevented the collapse of certain institutions previously considered to have been outside the safety net.

Make no mistake: these necessary moves were unprecedented and controversial. The U.S. government's financing of Treasury's actions required federal debt to rise sharply, and stabilizing the financial system temporarily boosted the size of the Fed's balance sheet.

The final numbers aren't in yet, but it now appears that the downturn in real gross domestic product (GDP) in the United States lasted about a year and a half, much shorter than the typical banking crisis downturn. Peak to trough, output fell about 4 percent, less than half the typical decline seen in past financial crises. While there are still some significant downside risks to the economy, in general, the outlook is improving. Of particular note, the capital markets – except for certain securitization markets – are now generally open for business. In addition, the big banks in the United States have been able to raise a large amount of equity capital to put themselves in a stronger position. I believe that Federal Reserve actions over the last year and a half have contributed very substantially to this improvement.

But there still is a lot of work to do. Smaller banks – especially those with large commercial real estate exposures – are under pressure, while households and smaller businesses find that their access to credit is still constrained.

Moreover, regulatory reform is essential to prevent this type of financial crisis going forward. We need to ensure that no financial institution is "too big to fail." This means we need Congress to enact a resolution mechanism that allows large, complex financial firms to be wound down smoothly, without the need for extraordinary interventions. In addition, we need to take steps to make the financial system as a whole more resilient and robust. This requires many steps – some already in train – including higher capital requirements for large banks, bigger liquidity buffers, and changes to ensure that compensation practices are consistent with safety and soundness and financial stability. It's a long list – there is no single silver bullet – and it will take time, but the regulatory community and the political leadership will fail to meet our shared responsibility as stewards if we do not implement the necessary reforms in a timely and effective manner.

Outlook for the recovery and risks from the financial sector

The U.S. economy has begun to recover. Growth in the second half of 2009 was a bit stronger than expected and the pace of layoffs has diminished. We currently expect that the economy will keep expanding, but at a somewhat slower growth rate than during the second half of 2009 as the temporary boost from the inventory cycle fades and the effects of the stimulus bill gradually weaken. With modest growth, we expect price pressures to remain well contained.

Nonetheless, it's far too early to pop the champagne corks. While the U.S. economy is growing, unemployment remains unacceptably high and certain impediments could restrict growth in the near term. One set of challenges are current conditions in the financial system.

The initial stages of the financial crisis have been widely attributed to a rapid rise in residential mortgage defaults. Many large financial institutions turned out to have direct exposure – and often indirect exposure through complex linkages – to residential real estate, and found themselves facing severe funding problems as the value and liquidity of their assets sharply diminished.

As the real economy slipped into recession in 2008 and unemployment began to rise, other financial instruments came under stress, including commercial real estate loans and instruments based on these loans. Commercial real estate loans are frequently originated by medium-sized regional banks that have significant expertise in their local areas and are often held in the lending bank's portfolio.

In many parts of the United States, including Puerto Rico, these commercial real estate loans have now soured, and many banks are seeing the value of their assets decline and their revenues shrink. In extreme cases, some banks have become insolvent. Finding ways to address problem assets and the health of the exposed banks is fundamental to restoring the banking industry to the firm footing that is needed to properly support economic growth.

To bring this point home, let me step back and offer some observations on the importance of a well-functioning financial system. A healthy banking sector is crucial for economic growth because banks and other parts of the financial system play a key role in determining how savings are allocated among competing projects and users of credit. If households and businesses cannot get credit on reasonable terms, then the economy sputters. To underline this point, the Fed and Treasury did not intervene during the recent crisis to save the financial system (and with it, some big financial firms) for its own sake. We intervened because a collapse of the financial system would have done irreparable harm to Main Street. With the limited tools at hand, we made our choices (often between unattractive options) with the goal of supporting the economy, households and small businesses.

A well-functioning financial system is also crucial in fostering economic development. History shows that substantial risks to the economy come from a persistently weak banking sector. Economists have debated whether healthy banks drive real economic growth, or vice-versa, but a wealth of recent evidence suggests that the causality runs at least partly from banks to growth, and not just the other way around. So, from my perspective, getting Puerto Rico's banking system back onto solid footing is "job one" for supporting growth here.

Preparing Puerto Rico to benefit from recovery in the world economy

Of course, that isn't the whole story. Growth may also be impeded by factors that are specific to particular regions or policies.

I work in New York and live in New Jersey, where we know a thing or two about fiscal problems. Puerto Rico's large public debt has the potential to reduce its growth prospects as the world economy recovers. Puerto Rico's fiscal situation has deteriorated sharply over the last five years as the Commonwealth's recession has deepened. Throughout this period, public debt has risen quickly as revenues that are sensitive to economic activity – such as income taxes – have declined.

But the fiscal problem in Puerto Rico pre-dates the current crisis. Even when the economy was growing, public debt was growing even faster. This structural imbalance is difficult to sustain in the long run, and requires attention if Puerto Rico is to prosper.

A critical factor here is ensuring that the Commonwealth's tax system is designed to generate the revenue required to sustain government operations. Furthermore, any good tax system should satisfy three important criteria: simplicity, fairness and neutrality. The current system suffers from some problems that make it difficult to meet these tests and generate adequate revenue. In particular, high rates are levied on a narrow tax base.

One of the key public services funded by these taxes is education. Workers need skills to produce the complicated technological products of the future. There is clear evidence that workers with the sort of flexible thinking skills not easily duplicated by computers have seen their productivity and earnings rise, a trend that is likely to persist in the future. Thus, technology and skills are essential for healthy economic growth and for the financial health of workers and their families.

As the economy and financial system become more complex, financial literacy is also increasingly central to family financial well-being. Improved understanding of budgeting, saving, financial products and planning for retirement is not only a high priority for people in their own lives, but also for the Fed with its responsibility for monetary policy.

Education thus plays a key role in fostering upward mobility for future generations. All of this underscores the importance of achieving the best possible education for all of Puerto Rico's young people and making lifelong learning and skills development a part of everyone's future. Yet, about half of Puerto Rico's low-income students drop out of high school. Reducing this dropout rate will not be easy, but should also be a priority for the Commonwealth.

The private and public sectors both need accurate, timely and comprehensive economic statistics to perform effectively. It is impossible to make good decisions without a solid factual basis for those decisions. For example, the government needs good economic information to develop effective fiscal, economic development and regulatory policy. Likewise, to make the best production, investment and pricing decisions, businesses need accurate and timely information on things such as wages, income and prices. Poor quality information increases uncertainty and this uncertainty inhibits well-considered risk-taking and investment decisions.

Although Puerto Rico's statistical system was once a model for other countries, now there are major opportunities for improvement in comparison with the mainland and other countries. In recognition of this need, the government of Puerto Rico recently established the Institute for Statistics to work with its statistical agencies.

One key example of these efforts concerns the Consumer Price Index (CPI) as a measure of inflation. A recent study by the Institute, aided by the Department of Labor, found that the island's official inflation rate was overestimated by more than double between 2001 and 2006. Overestimating inflation can have tangible consequences, such as excessive wage increases in certain sectors that can damage the island's global competitiveness and cause unnecessary job loss.

Also thanks to the Institute, the government of Puerto Rico now has a release schedule, called the "*calendario*", for its statistical publications. This basic tool helps people, businesses and investors by ensuring that they use the latest available data for their decisions. It also boosts confidence in the data, which reduces economic uncertainty.

How the Fed is helping

There are many challenges ahead, and we are committed to being an active partner in confronting them. The Fed's most important roles in helping Puerto Rico, of course, emanate directly from our responsibilities for economic growth, stable prices and a resilient financial system. We continue to take the actions required to promote maximum sustainable growth in the U.S. economy. These efforts have and will continue to benefit the mainland and the Commonwealth.

In addition, we are working very closely with all of the banking supervisors and other key parties to facilitate an effective resolution to the current problems facing the island's banking sector. Some consolidation is likely needed to produce stronger, healthier institutions more able to make the sound lending decisions that support economic growth.

Let me also tell you a bit about how we are contributing "on the ground" here in Puerto Rico.

I mentioned financial literacy a few minutes ago. The Federal Reserve System and the New York Fed have taken a great interest in economic education and financial literacy and will continue to do even more in the future. I, personally, believe that financial literacy is essential so that households can make the type of good financial decisions that help to ensure better futures.

The New York Fed, along with many financial institutions and foundations in Puerto Rico, has created and supported the Economic and Financial Education Alliance of Puerto Rico. Over the past ten years, the Alliance has trained more than 400 high school teachers in economics and financial literacy. I would like to personally thank all the institutions whose devotion to this Alliance has made these education efforts possible.

These teachers take what they learned back to the classroom and many of their students enter the Federal Reserve Economics Competition. The students apply analytical skills to a local problem of their choosing and work as a team to create a presentation outlining their solution and responding to questions. The winning team develops skills – in analysis, presentations and teamwork – that will help them in their future studies and careers in the knowledge economy.

The New York Fed is also supporting the Office of the Commissioner of Financial Institutions in its two-week expo, where last year 20,000 people saw presentations and received financial counseling.

We have also had a productive relationship with our good friends at the Puerto Rico Bankers Association. Each year during “Community Reinvestment Act Week,” our staff highlights new ideas and products especially suited to the Puerto Rican market.

For example, this November we held a forum for Puerto Rican and U.S. Virgin Islands financial institutions, state and local governments, and nonprofit organizations to introduce “Bank On,” a financial product proven to attract under-banked people into the financial mainstream. Since then, several local banks have formed a group to explore how to best implement it here.

Another example of collaboration is our work with the Bankers Association and local universities. During the fall, we held a “Financial Awareness Video Contest” for college students. This pilot project explores building peer-to-peer financial awareness among young adults by having contestants create a 90-second video. We look forward to hosting the first place winners during their trip to New York in the spring.

To improve our understanding of the Puerto Rican economy, the New York Fed has joined a group of local businesses – including some represented here – to sponsor and fund a household survey, undertaken by the Center for the New Economy, our hosts today, to benchmark Puerto Rican consumer finances. As of today, the data have been collected and Fed economists are collaborating with the CNE to provide technical assistance, to make the results of this study public and to make these data available for further research.

To help businesses and government in Puerto Rico, we have also been providing technical assistance to Puerto Rico’s new Institute for Statistics. We recognize the importance of this work and applaud its efforts to improve Puerto Rico’s inflation measures, national income accounting and business activity measures, just to name a few.

All of these activities, from monetary policy and financial regulation to fostering community development and economic literacy and measurement, complement and reinforce each other. Our policy actions are most effective when people understand how financial markets work. Our decisions are always better when we are well informed about the concerns of families and businesses. Thus, outreach to the region and communities we serve is an important part of my job. Thank you for your kind attention. I would be happy to take a few questions.