

## **William C Dudley: The competitiveness of Puerto Rico's economy – reducing the cost of doing business and improving labor market opportunities**

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 Puerto Rico Chamber of Commerce Annual Convention, Fajardo, Puerto Rico, 29 June 2012.

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Good morning and greetings from New York City. I sincerely thank the Chamber for giving me the opportunity to address your annual meeting. Unfortunately I am unable to be in Puerto Rico in person, because I have a broken leg and am under doctor's orders not to fly. The good news is that I am on the mend and that I have this opportunity to speak to you via video.

We at the New York Fed are pleased that Puerto Rico is part of the Second Federal Reserve District that we represent in the Federal Reserve System. We are committed to the people of the Island and to its growth and prosperity. Our commitment is reflected in our ongoing work with our many partners on the Island. Last spring, with the Puerto Rico Chamber of Commerce and other local partners, we co-sponsored a forum aimed at helping small businesses in Puerto Rico learn about export opportunities. We have been involved with education on the Island for two decades, including by helping to set up the Alianza. Today we help promote financial literacy through a video competition in partnership with the Puerto Rican Bankers Association.

Our banking supervisors work to strengthen the financial system so it can readily supply credit to families and businesses, while our research economists monitor and analyze local economic conditions. This analysis – along with similar analyses from other regions across our nation – feeds into the decisions the Federal Reserve makes on monetary policy.

In support of this work, I and other senior officials have traveled to Puerto Rico a number of times in recent years and met with a wide range of stakeholders, including university officials, students, business leaders, entrepreneurs, bankers and government officials.

What we learn during these engagements helps to shape our understanding of the Puerto Rican economy and our efforts to support it. I have seen numerous examples of expansion and growth. This gives me confidence that Puerto Rico has the capability to be an economic success story. Nevertheless, these local engagements have also confirmed to me that conditions are not what we want them to be – in particular, growth and expansion are not happening broadly enough. The task of putting the Island on a path of robust, sustainable and inclusive growth remains a work in progress.

During my visit here in March 2011, a number of business and community leaders expressed their concern that the economy had lost competitiveness. These local leaders asked if we would look at what might be holding back growth on the Island. Much high quality work has already been done on this subject by local experts. However, they thought it might be helpful for the New York Fed, as an independent third party, to evaluate what might be done to promote competitiveness and productivity on the Island.

I readily agreed that we would do so. I commissioned a team of economists from our Research group and other experts from our international and outreach teams, to analyze the challenges facing Puerto Rico. I asked them to put forward some recommendations on how to capitalize on the Island's strengths and restore growth.

The report released today on the competitiveness of Puerto Rico's economy, is the product of their work and extensive consultation with local, national and international experts. I have

read it closely and commend it to your attention. The report is intended as nonpartisan technical analysis and should be viewed in that vein. Even those who do not agree with every aspect of the analysis, I hope, will acknowledge that this is a serious, good-faith effort to examine, in detail, a number of important issues that deserve attention. Of course, many of these issues can only be considered as part of the political process. It is for the people of Puerto Rico to judge the appropriate trade-offs involved – not me, certainly, or my staff at the New York Fed.

In a few moments Jamie McAndrews, executive vice president and director of research, will summarize the report and its recommendations. Before he does so, I would like to share with you my assessment of economic conditions on the mainland and in Puerto Rico.

As always, what I have to say reflects my own views and not necessarily those of the Federal Open Market Committee (FOMC) or the Federal Reserve System.

### **National economic conditions**

The mainland U.S. economy has continued to slowly recover from the after-effects of the housing boom and bust and the financial crisis. But the recovery has been disappointing. Despite a monetary policy that has been extraordinarily accommodative by historical standards, the economy has grown only about 2 percent over the past year. After a brighter start to the year, economic momentum has slowed in the last few months. (This may partly be a payback for the mild winter, which brought forward some spending.) Employment growth remains positive, but has slowed considerably of late as the economy has lost forward momentum, and the unemployment rate remains elevated.

The headwinds retarding recovery are well known. Many consumers have been deleveraging in response to the large losses in wealth generated mainly by the collapse in home prices. The supply of credit – particularly mortgage credit – to many families remains constrained, limiting the degree to which many households can fully benefit from low interest rates.

Although there have been some positive signs in the housing market recently, housing activity nevertheless remains at very low levels. The sector has been restrained by several factors including the large shadow inventory making its way through the foreclosure pipeline, tight underwriting standards for new mortgage origination, and the sharp slowdown in household formation.

Although the corporate sector as a whole is now relatively healthy, there still is a significant constraint on the availability of credit to small business. Business investment continues to expand, but at a restrained pace. I presume that this partially reflects uncertainty over the economic outlook, including the risks around the evolution of U.S. fiscal policy and the crisis in Europe.

Fiscal policy has already become restrictive as state and local governments have cut expenditures in response to revenue shortfalls. Moreover, we face the so-called “fiscal cliff” at the start of next year. At the beginning of 2013, federal fiscal policy is scheduled under current law to become sharply contractionary, with abrupt increases in taxes and cuts in spending. Businesspeople tell me that the uncertainty about how Congress and the Administration will deal with the fiscal cliff – and our fiscal challenges more broadly – is already inhibiting hiring and investment. The fiscal cliff represents a threat to the recovery that is wholly avoidable. But we will only avoid it if our politicians act responsibly. We need a credible strategy for bringing down the federal budget deficit over time in a manner supportive of ongoing economic recovery. Any plan should start slowly, but build steadily over time. It should be bipartisan in nature so that the plan is viewed as sustainable across the political cycle.

Meanwhile the crisis in the eurozone has resulted in a sharp slow-down in economic growth in Europe and tighter financial conditions globally. It has hurt U.S. consumer and business confidence and is already a material drag on U.S. growth. Economic momentum in many other regions of the world has also slowed somewhat and this is also restraining the demand for U.S. exports.

Assuming that Congress avoids the fiscal cliff and European leaders successfully manage through their challenges, there are solid grounds for expecting that growth will gradually strengthen in coming years. U.S. banks are healthier and credit conditions, while still tight, are gradually easing, the housing sector is showing early signs of recovery, and households appear quite far along in the deleveraging process.

On the inflation side, we have succeeded in delivering inflation very close to our 2 percent price stability objective. Over the past year or so, price trends have been a bit stickier than one might have anticipated given the large amount of slack in the economy. To some degree, this likely reflects earlier upward pressures on commodity prices, the anchoring exerted by stable inflation expectations, and the stickiness of nominal wages. With gasoline prices now falling sharply and upward pressures from apparel prices now appearing likely to dissipate, I expect that inflation will decline a bit in coming months, falling somewhat further below our 2 percent objective.

More generally, there are several reasons to think that inflation will remain moderate. First, the economy continues to operate with significant slack. Second, measures of underlying inflation show little upward pressure, and the growth rate of nominal labor compensation is low and stable. Moreover, inflation expectations remain well-anchored. Taking into account all these factors along with our current stance of monetary policy, I anticipate that inflation will be slightly below our 2 percent long-run objective over the next few years.

One of the challenges I face as a policymaker is how much to adjust my medium term economic forecast in response to near-term developments, particularly when there is elevated uncertainty. Although I have made some adjustments of late, they have been relatively modest to date. That is because there are important issues – such as the outlook in Europe and the degree to which we have lost underlying momentum at home – where more information is needed before making an informed judgment.

Although some of the current uncertainties will take time to resolve, I can imagine material data on a number of dimensions could become available in the coming weeks and months that could lead me to adjust my forecast further. I will be paying particularly close attention to whether domestic momentum and hiring picks up now that the pay-back for the mild winter is over, and whether financial conditions, which are heavily influenced at present by developments in Europe, ease or tighten further.

I am the vice-chairman of the Federal Open Market Committee, the Fed committee that sets monetary policy to promote its statutory goals of full employment and price stability. Last week, the committee reaffirmed that it currently anticipates that the Federal Reserve's federal funds rate target will remain exceptionally low – which I understand to mean at its current level – at least through late 2014. The FOMC also voted to provide additional support for economic activity by extending its maturity extension program – popularly referred to as Operation Twist – through the end of the year. This extension means that we will be buying an additional \$267 billion of longer term Treasury securities, paid for by selling or redeeming the same amount of shorter term Treasuries.

This action reduces the supply of longer dated Treasury securities on the market and lowers longer term interest rates relative to where they would otherwise be in the absence of such a program. That puts downward pressure on corporate borrowing costs and mortgage rates, and supports asset prices such as housing and equities – all of which promotes growth.

In addition, the FOMC adopted new language to describe its policy outlook, stating that it is “prepared to take further action as appropriate to promote a stronger economic recovery and

sustained improvement in labor market conditions in a context of price stability.” I will let those words speak for themselves.

### **Local economic conditions**

Now let me turn to economic conditions in Puerto Rico. Puerto Rico’s real, or inflation-adjusted Gross National Product has declined for the past four years and this has been accompanied by a sharp decline in the real income of Island residents. According to a monthly index of economic activity produced by the Government Development Bank for Puerto Rico, economic activity began to decline as far back as 2005. Although the index has been stable for the past several months and this may be a signal that the economic downturn on the Island may have ended, a solid recovery has yet to take hold and conditions remain challenging.

The job market remains a trouble spot for the Island’s economy. Total employment fell by about 13 percent or roughly 140,000 jobs, between its peak back in 2005 and mid-2010. This is nearly double the 7 percent job loss on the mainland. For the past two years, employment has appeared to have bottomed out, but there has been little evidence of recovery.

The Island’s unemployment rate has fallen by more than a percentage point over the past year, but this is not necessarily good news. The fall was largely the result of a fall in labor force participation. At 14.8 percent the unemployment rate remains unacceptably high.

High unemployment and low labor force participation remain perhaps the biggest challenges to the Puerto Rico economy. Even in relatively prosperous times, the unemployment rate on the Island has been more than double the rate on the mainland. High unemployment and low labor force participation are especially serious problems for young workers and are perhaps the clearest evidence that Puerto Rico needs to make better economic progress.

Many of the current problems facing Puerto Rico relate not just to cyclical weakness but to deeper structural challenges. This brings us to the subject of the report we issued today.

I do not presume that this report is the last word on these important questions. We do not presume to claim that we have all the answers. Rather, I hope that it is the start of a constructive and bipartisan debate that will advance good public policy and a better future for the people of Puerto Rico. I also hope that it will be read and considered beyond the business and government community, across the society at large. The goal we seek is not simply business success and expansion, but broad-based prosperity with rising standards of living and greater opportunities for all Puerto Ricans.

I want to thank you again for the opportunity to address the Chamber. Jamie McAndrews, executive vice president and director of research, will now talk about the report we released and lay out its findings and recommendations.