William C Dudley: The road to recovery – Puerto Rico and the mainland

Remarks by Mr William C Dudley, President and Chief Executive Officer of the Federal Reserve Bank of New York, at the E-3 Summit of the Americas: Export Trade Basics Forum 101, San Juan, Puerto Rico, 1 April 2011.

*   *   *

Good morning. I am pleased to be back in Puerto Rico to speak to you and meet with various communities in the Commonwealth. Each visit gives me a chance to deepen the Bank's relationship with the island. Last year I visited La Cantera and met with community leaders, business people, academics, bankers and government officials. This year I visited Goya Foods – the oldest Hispanic-owned plant in our country with subsidiary facilities in my home state, New Jersey, and upstate New York. I will also meet with a similar wide range of people to talk about what we do and to hear first-hand the economic and financial issues important to Puerto Ricans so that I can best represent all my constituents in my work at the Fed. Your beautiful island is unique within the Second Federal Reserve District. For me, personally, being here also recalls special memories of my childhood visit with my parents.

I thank the organizers for inviting me to speak at the Export Trade Basics Forum, to help kick off the week-long summit on Education, Exports and Entrepreneurship that begins next week. This morning I will talk about economic conditions in the mainland and in Puerto Rico, paying particular attention to the developments since my visit last year and to the role of exports. 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.

Introduction to the New York Fed

By way of introduction, let me start with a synopsis of what the New York Fed is, what we do, and what makes my job so interesting.

The New York Fed is part of the Federal Reserve System, America's central bank, which was created by Congress in 1913. With this act, Congress delegated to the Fed System its constitutional authority to manage the supply of money in the nation's economy. Congress designed the central bank to be decentralized, representative of all regions of the country – including Puerto Rico and the Virgin Islands – and independent of the political process.

The Fed System is comprised of the Board of Governors in Washington, D.C. – a federal agency currently led by Chairman Ben Bernanke – plus 12 regional Reserve Banks that span the country. For example, the district overseen by the New York Fed includes all of New York, the 12 northern counties of New Jersey; Fairfield County, Connecticut; Puerto Rico and the U.S. Virgin Islands.

Each Reserve Bank is distinct, with its own charter and a board of directors drawn from its district, but overseen by the Board of Governors. The law that created the Federal Reserve made the central bank independent so that policymakers could make decisions about monetary policy – such as whether to adjust interest rates – in the national interest, somewhat insulated from political pressure. However, the Fed is accountable to Congress.

Congress has set an explicit objective for monetary policy: To pursue the highest level of employment consistent with price stability. This objective is often referred to as our "dual mandate," because it combines two goals: high employment, and low and stable inflation. In order to promote these objectives, we also pay close attention to financial stability, because without financial stability, it is very hard to achieve our goals for jobs and inflation.

The FOMC consists of the Board of Governors plus the presidents of each of the 12 district Banks. It meets in Washington, D.C., eight times per year to deliberate and vote on monetary policy. As the current New York Fed president, I am vice chairman at these meetings. At these meetings, each committee member presents his or her current outlook for the economy. For these assessments, we augment input from our research departments with critical information about local economic conditions supplied by our boards of directors, regional advisory councils and conversations with local stakeholders. My visit to Puerto Rico today is a part of these regional activities, in which I learn first-hand about the economic and financial conditions important to Puerto Ricans.

One thing that makes my job even more interesting is that New York has some roles unique within the Fed. For example, the New York Fed is the Reserve Bank charged with implementing monetary policy. This means that at the direction of the FOMC, we buy and sell Treasury securities. We are also the eyes and ears of the Fed on Wall Street, and we supervise many of the largest financial institutions in the country. We operate Fedwire® – the conduit for large money transfers between banks. And, we provide banking services to the U.S. Treasury, and central banks and governments from around the world.

Finally, I must mention that the New York Fed's district could be the most diverse in the System: ranging from the urban density of New York City to the forested sparseness of the northern Adirondacks, to here in the Caribbean island of Puerto Rico. All in all, there is a lot to keep my colleagues and me quite busy – even in normal times.

U.S. economic outlook

Now, what is the outlook for economic activity, employment and inflation on the mainland? In particular, what are the areas of vulnerability that we should be most concerned about?

I am pleased to say that the economic outlook for the mainland has improved in the past six months. Despite this, we are still very far away from achieving our dual mandate of maximum sustainable employment and price stability. Faster progress toward these objectives would be very welcome.

On the activity side, a wide range of indicators show a broadening and strengthening of demand by households and production by firms. For example, on the demand side, after an unusually deep retrenchment during the recession, consumer spending has begun to recover, and that recovery strengthened considerably in the final months of 2010. Not surprisingly, businesses' orders and production are following suit.

These factors led to a 3.1 percent growth rate in our most comprehensive measure of national output (real, or inflation-adjusted, gross domestic product or GDP) in the fourth quarter of 2010. Growth for the first quarter looks likely to be similar, near 3 percent. In my view, the revival in demand and production – while not as strong as desired – suggests that we may be much closer to establishing a virtuous circle that will support stronger growth. What I have in mind is a cycle in which rising household and business demand generate more rapid income and employment growth, which in turn bolsters confidence and leads to further increases in spending. This is why we upgraded our assessment of the economy at last month's FOMC meeting, noting the economy is now on a "firmer footing". The major missing piece of the puzzle has been the absence of strong payroll job growth. We will need to see sustained strong employment growth in order to be certain that this virtuous circle has become firmly established.

With respect to the labor market, we have seen some conflicting signals. On one hand, the unemployment rate has fallen sharply over the past four months, dropping to 8.8 percent from 9.8 percent in November. On the other hand, payroll employment gains have been relatively modest.

The good news is that the data on payroll employment for the past two months was better than for the prior months. The economy added a notable 216,000 jobs in March. Particularly encouraging is the growth of manufacturing jobs. Over the past year we have added factory jobs at the fastest pace since the 1990s. Other labor market indicators, such as initial claims for unemployment insurance benefits and the employment components of both manufacturing and nonmanufacturing business surveys have also shown improvement recently.

Although there is still uncertainty over the timing and speed of the labor market recovery, I am hopeful that job growth will increase more rapidly in the coming months. We would welcome this. A substantial pickup is sorely needed. Even if we were to generate growth of 300,000 jobs per month, we would still likely have considerable slack in the labor market at the end of 2012.

So, why is the economy finally showing more signs of life? In my view, the improvement reflects three developments.

First, household and financial institution balance sheets continue to improve. On the household side, the 2008–09 rise in the saving rate appears to have stabilized in the 5 percent to 6 percent range. Meanwhile, the amount of money that households need to service their debt (for mortgages, cars, credit cards) has fallen sharply to levels that prevailed during the mid-1990s. Debt service has been pushed lower by a combination of debt repayment, refinancing at lower interest rates and debt write-offs. Financial institutions have strengthened their balance sheets by retaining earnings and by issuing equity. Bank lending standards, while still tight, have begun to ease somewhat. As a result, some measures of bank credit are beginning to expand again.

Second, monetary policy and fiscal policy have provided support to the recovery. On the monetary policy side, we at the Fed have maintained unusually low levels of short-term interest rates and engaged in large-scale asset purchases. These measures have fostered a sharp improvement in financial market conditions. On the fiscal side (that is, government spending and taxation), the economy has been supported by the shift in policy to help support growth. In particular, the temporary reduction in payroll taxes could have a strong impact on growth during the first part of this year.

Third – and very much linked to the topic of this meeting – is growth abroad. Much of the rest of the world – especially the emerging market economies – have been growing strongly. This growth has led to an increase in the demand for U.S.-made goods and services. Over the four quarters of 2010, real, or inflation-adjusted, exports rose 9.2 percent. All told, real exports accounted for about 40 percent real GDP growth in 2010. In a few moments, I will talk about how this growth abroad also presents an opportunity for Puerto Rico.

The firming in economic activity, in short, is due both to natural healing and past and present policy support.

In this regard, it is important to emphasize that we at the Federal Reserve have been expecting the economy to strengthen. We provided additional monetary policy stimulus via the asset purchase program to help ensure that the recovery regained momentum. A stronger recovery with more rapid progress toward our dual mandate objectives is what we have been seeking. This is welcome and not a reason to reverse course.

Yet, we must not be overly optimistic about the growth outlook. The coast is not completely clear – the healing process in the aftermath of the crisis takes time and there are still several areas of vulnerability and weakness. In particular, housing activity remains unusually weak and home prices have begun to soften again in many parts of the country. State and local government finances remain under stress, and this is likely to lead to further spending cuts, tax increases, or job losses in this sector that will offset at least a part of the federal fiscal stimulus.

Moreover, in recent weeks we have experienced several shocks from abroad that could have some impact on the economy's forward momentum, at least in the short term. For example, higher oil prices cut into household purchasing power, and the tragedy in Japan is leading to supply disruptions that may dampen growth somewhat in the near-term. Also, conditions in

Japan, the Middle East and North Africa remain uncertain and could worsen, with negative implications for global economic growth. Furthermore, we cannot ignore the risks stemming from the longer-term fiscal challenges that we face in the United States.

But in the near-term, the most immediate domestic problems may recede rather than become more prevalent. On the housing side, stronger job growth should lead to more household formation. For example, more young people will be able to move out of their parents' homes when they get jobs. This trend should provide more support to housing demand. On the state and local side, a rising economy would boost sales and income tax revenue, and help narrow near-term fiscal shortfalls.

We also need to remain watchful to ensure that low interest rates do not foster a buildup of financial excesses or bubbles that might pose a medium-term risk to both full employment and price stability. In this regard we monitor interest rates on risky and safer assets. An unusual narrowing of these differences could signal that risk is not being appropriately assessed. These differentials for risk on U.S. assets in general do not seem obviously compressed today.

On the inflation side of the ledger, the risk of deflation is greatly diminished. At the moment, both total, or headline, inflation and core inflation, which excludes the volatile food and energy prices, have increased but remain below levels consistent with our dual mandate objectives – which most members of the FOMC consider to be 2 percent or a bit less on the personal consumption expenditures measure. Moreover, the rise in commodity prices is likely to put further upward pressure on headline inflation in the coming months. Provided commodity prices level off around current levels, the effect on inflation should be transitory. But we will need to ensure that commodity price pressures do not cause inflation expectations to become unmoored. If that were to occur, it would be more difficult to keep inflation in check.

To sum up, economic conditions have improved in the past year. Yet, the recovery is still tenuous. And, we are still far from the mark with regard to the Fed's dual mandate. In particular, the unemployment rate is much too high.

Economic conditions in Puerto Rico

Now let me turn to economic conditions in Puerto Rico. In contrast to the situation during my last visit, I am pleased to see signs that the Commonwealth may finally be emerging from this painful recession. Nevertheless, conditions remain difficult for many families.

The recession here has been deeper than the downturn on the mainland. By mid-2010, total employment in Puerto Rico had fallen by 13 percent or 138,000 jobs from its peak in 2005. This is almost double the 7 percent job loss on the mainland from the employment peak to its trough. Furthermore, the recession in Puerto Rico has lasted about five years – three times as long as the mainland downturn. The recovery has also lagged that of the mainland. While the mainland's economy began to recover in mid-2009, Puerto Rico's economy continued to decline for another year.

But, since mid-2010 there have been promising signs: Recently released revisions suggest that job growth on the island, while still very weak, improved modestly since last summer. And most of the weakness since then has not been broad-based, but instead concentrated in construction and manufacturing. The unemployment rate has come down by a full percentage point since its peak. However, at just over 16 percent, it remains unacceptably high.

Inflation generally remains subdued on the Commonwealth – although there has been some recent volatility. After a period of falling prices in 2009, inflation picked up in December 2009 with annualized rates of around 4 percent for a few months – with medical care a key driver for these increases. Since June 2010, reported inflation rates have reverted to a range between 1 percent and 2 percent. However, the rise in food and energy prices is likely to push inflation somewhat higher over the next few months.

To help keep track of conditions in Puerto Rico, we can now look at the Institute of Statistics' new Manufacturing Purchasing Managers Index (PR-PMI), which is conducted in conjunction with the Puerto Rico Manufacturers Association and Scotiabank. The survey shows that business conditions on the island were steady in January, following improvement at the end of 2010. The PR-PMI has signaled growth for seven of the past nine months. It will take some time before this new index has a clear track record, but we welcome this source of timely information on economic activity in Puerto Rico.

Now, what about credit conditions in Puerto Rico: how much debt do families have and how have they been doing in terms of meeting their obligations? I needn't tell you how important it has been to monitor these trends over the course of the Great Recession. Using a new source of information – the New York Fed's Consumer Credit Panel – we can now track how families in the mainland and Puerto Rico have managed their credit in recent years.

Overall, compared with the mainland, Puerto Ricans avoided much of the recent boom and bust in the use of household credit. Yet, signs of distress are readily apparent, owing to the long and deep recession here. Unlike the mainland, households on the island did not raise their borrowing much in the run-up to the recession. Thus, it is not surprising that Puerto Rico did not see the sharp spike in loan delinquencies that many areas saw from late 2007 to early 2009. Instead, Puerto Rico's delinquencies on household debt – that is, the proportion of debt where payments are 90 or more days late – have risen gradually as the recession has persisted. In 2005, households were behind on about 5 percent of the total debt. As of 2010, they were delinquent on about 9 percent of the debt, about the same as the national average – reflecting the stress imposed on many families by the deep and long recession.

The outlook and exports

Looking ahead to the rest of 2011, I see grounds for cautious optimism. In particular, exports, which have been so important to the economic recovery on the mainland, have the potential to contribute to growth here in Puerto Rico as well.

Currently, Puerto Rico runs a sizeable trade surplus, selling more products to the world than it buys. In 2009, the latest year for which full-year data are reported, the value of exports was roughly $60 billion compared with roughly $40 billion of imports. Based on data through November, exports grew briskly, by about 10 percent, in 2010.

What does Puerto Rico export? Pharmaceuticals are by far the island's largest export. In addition, Puerto Rico is a successful exporter of medical equipment, computer and electronic products, and electrical equipment.

The mainland is Puerto Rico's primary trading partner, accounting for half of the island's imports and three-quarters of its exports. There are many reasons for this. While Puerto Rico interacts with many other economies, for generations the mainland United States and Puerto Rico have had a special multifaceted economic relationship. One of the most obvious of these ties is the free flow of goods between the mainland and the island. 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.

The island runs a surplus with the mainland that accounts for much of the island's overall surplus. So the signs of a further pickup in economic growth on the mainland bode well for the island.

Puerto Rico's export markets also extend overseas. Aside from the U.S. mainland, the top export markets for the Island are Germany, Netherlands, Belgium and Spain. Exports to these four countries combined exceeded $11 billion in 2009 and have grown by more than 30 percent since 2007.

The success that Puerto Rico has in selling its goods and services to industrialized countries bodes well for the island's future. As more emerging economies narrow the gap between themselves and the more developed countries, the market for Puerto Rico's goods could well expand accordingly. Going forward, I would not be surprised to see Puerto Rico's exports rise further as your companies take advantage of the opportunities presented by the rapidly emerging economies.

At your upcoming forum and summit, you'll learn more about how to develop export markets for your products. I applaud your efforts to do so, as an important component of sustaining the vigor of the economic recovery in Puerto Rico.

The long view and the New York Fed's role

Although the signs I've mentioned suggest that the recession is over, the road to sustained economic growth is likely to be challenging in the near term.

In its favor, Puerto Rico has some important intrinsic advantages. These include natural beauty, a hospitable climate and unique status as a major U.S. economic and population center in the Caribbean. Perhaps just as important, the island has a relatively well-educated workforce. Research shows quite convincingly that abundant human capital is an important ingredient for a thriving economy.

We at the New York Fed aim to do our part to help sustain growth in the Commonwealth. For example, we co-sponsor a financial awareness video competition for college students here and the Community Reinvestment Act Week activities with the Puerto Rico Bankers Association. And, as a member of the Alliance for Economic and Financial Education we promote economic and financial education via teacher training, a high school economic competition, and a speaker series. The New York Fed also has several ongoing programs of technical assistance in Puerto Rico. We partnered with other organizations throughout the year to help provide technical training for community development professionals. We cover the costs of two to three professors who are engaged in macroeconomic and monetary policy research to attend our annual symposium on current economic conditions held at the New York Fed.

We also recognize that a healthy banking system and accurate economic statistics are both important components of a favorable business climate. To improve our understanding of the Puerto Rican economy, the New York Fed joined a group of local businesses to sponsor and fund a household survey, undertaken by the Center for the New Economy to benchmark Puerto Rican consumer finances. To help businesses and government in Puerto Rico, we have also been providing technical assistance to Puerto Rico's new Institute for Statistics in launching the new monthly manufacturing survey I mentioned earlier. We applaud this and other efforts to improve the measurement of economic conditions in Puerto Rico.

As a financial regulator, the New York Fed works to help the financial system run smoothly so that it can support economic growth. We are working hard to prevent the type of financial crisis that we recently experienced from recurring in the future, in a way that does not inhibit businesses from growing and prospering.

We are working closely with all of the banking supervisors and other key parties to facilitate an effective resolution to the problems facing the island's banking sector. Last year, some of Puerto Rico's banks were consolidated and many improved their balance sheets by selling underperforming assets. Both of these steps are likely to produce stronger, healthier institutions more able to make the sound lending decisions that support economic growth.

All of these activities, ranging from effective monetary policy and prudent financial regulation to fostering economic literacy and measurement, complement and reinforce each other to help support a strong economy in Puerto Rico.

Conclusion

To sum up, the mainland economy experienced a pick-up in activity during the second half of 2010 that shows signs of continuing in 2011. The recovery in Puerto Rico has taken longer to get off the ground, but now shows signs of firming. On the mainland and in Puerto Rico, unemployment remains stubbornly high, but many indicators suggest that conditions are in place for stronger employment growth in the coming months.

With government and business leaders like yourselves working together to build a better future for Puerto Rico, I am hopeful that we will soon be able to look back at 2010 and see not only the end of the island's long recession but also the beginning of an era of growth and prosperity for Puerto Rico.

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