William C Dudley: Opportunities for economic growth in Puerto Rico

Remarks by Mr William C Dudley, President and Chief Executive Officer of the Federal Reserve Bank of New York, to representatives of Puerto Rico's business and academic communities, San Juan, Puerto Rico, 29 November 2016.

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I am very pleased to be here and to have this opportunity to speak with representatives of Puerto Rico's business and academic communities. In my remarks, I will discuss the lessons learned from municipalities in the United States that have faced crises over the years—such as New York City—and what those outcomes might imply for Puerto Rico as it seeks to restore and sustain economic growth. I will also touch briefly on the Puerto Rico Small Business Survey, a new survey from the New York Fed that focuses on the business performance, financing needs and borrowing experiences of firms across the Island. As always, what I have to say reflects my own views and not those of the Federal Open Market Committee or the Federal Reserve System.

My meeting with you today is part of the New York Fed's continuing efforts to understand what is going on at the grassroots level within our Federal Reserve district. We plan these trips so we can interact with a diverse group of stakeholders. These meetings help me get a more complete picture of economic conditions on the Island and a fuller understanding of the major issues and concerns. This is the third time we have visited Puerto Rico in the past five years.

Yesterday, I met with Governor-elect Rosselló to discuss the transition into his new role and the key challenges for his upcoming term. I also spent time with members of El Colaboratorio, a shared workspace organized by the Foundation for Puerto Rico. I attended a roundtable discussion with local businesses and spoke with former and current members of several of the New York Fed's advisory councils.

Earlier this morning, I met with the heads of a number of financial institutions and the University of Puerto Rico's interim president, Celeste Freytes. Following this visit, I will meet with the leadership from Parallel18, an economic development initiative that attracts early-stage, high-potential startups to Puerto Rico. Finally, I will join the leadership of the Boys and Girls Clubs of Puerto Rico for a discussion on the organization's initiatives and a site visit to one of the clubs to learn about workforce development programs and youth services.

As we all know, the Commonwealth of Puerto Rico has been through a very rough 10 years. The economy has been in a long slump that could easily be called a depression. Residents have endured a terrible drought, periodic blackouts and a fiscal crisis. I don't need to elaborate on all of the struggles Puerto Rico continues to face. The Island has been suffering from a vicious cycle. As employment declines, people move to the mainland to find jobs. Accordingly, economic activity and tax revenues decline, forcing the government to raise taxes and cut spending, which further reduces employment and prompts still more residents to move. At this point, the outlook for anyone who has been living here must be bleak, and it may be hard to imagine this situation turning around anytime soon. And yet, history tells us that a turnaround, though not inevitable, is indeed achievable.

Lessons from past crises

New York City is probably the most famous example of a municipality that experienced a major fiscal crisis, recovered and is now thriving. New York City's experience is viewed, in retrospect, as a major success, and some, including myself, have pointed to it as a hopeful example of what could come to pass in Puerto Rico. But, there are important caveats to the New York City story and its applicability to the Commonwealth.

Like Puerto Rico, New York City experienced a number of years of both political and economic pain as a result of its fiscal crisis in the 1970s. On the political side, New York City residents lost a large measure of their ability to chart their own fiscal direction for several years. Decisions about tax and spending policies were removed from elected city officials. The Emergency Financial Control Board was empowered to review all fiscal decisions of local officials and demand changes to the city's budgets. Part of the city's tax base was dedicated to bond repayment—essentially handing it over to the city's creditors. For 10 years, the city could not access the debt markets without support from the state.

The economic pain was also very real. More than 70,000 city government workers were cut from the payrolls in 1975 and 1976. City residents faced dramatic service reductions—fire houses closed, schools and police precincts had fewer resources, and crime continued to rise for many years.

It is also important to note that New York isn't the only U.S. city that has been through a major fiscal crisis. Cleveland, Philadelphia, Washington, D.C. and, most recently, Detroit have all struggled to manage their budgets, and all ultimately reached a point when they were unable to pay their bills. As a result, these cities lost their fiscal autonomy to one degree or another. In the case of New York City, this turned out relatively well, as the short-run loss of decision-making power led to a strong economic rebound that eventually restored the city's ability to finance its own choices.

So, is New York City's experience really all that instructive for Puerto Rico? With the advantage of hindsight, it now seems almost obvious that New York City's fiscal crisis was only going to be a detour. The city's economy had many fundamental strengths, so it only needed some assistance to get back on track. Still, it's worth pointing out that this was by no means clear at the outset the crisis in the mid-1970s. Then, many commentators looked at New York City and other large cities as outmoded forms of economic activity, unlikely ever to recover.

While we do not have great measures of economic activity for cities, population change is a good indicator of how attractive a place seems to be. By that measure, New York City at the time was seen to have very poor prospects—the city's population fell by over 10 percent during the 1970s. So, New York City's eventual bright future was far from clear as its fiscal crisis was unfolding.

Of course, not every city that has faced a fiscal crisis has the same track record. Relative to cities that had similarly grim outlooks, New York City's rebound has been much stronger. In Detroit, there are hopeful signs, but it's too soon to tell how things will turn out. Both Washington, D.C. and Philadelphia experienced multiple decades of population declines leading up to their crises. These population declines reversed in the 2000s. Washington, D.C.'s population actually grew over 5 percent between 2000 and 2010, a rate even faster than that of New York City. Cleveland's fiscal reforms, on the other hand, were less comprehensive, and the city has never really turned itself around. Its population in 2010 was less than half the level of 1960.

The different performances across cities reflect the complex interplay of native endowments, economic conditions and fiscal outcomes. As in Puerto Rico, the fiscal woes of many of our largest cities have been closely related to long-term economic transformations—essentially, changes in the industrial specialization that occurred in those particular places. In the case of New York City, the transformation was from manufacturing to services, and it took a generation to complete. The city's management of that transition was far from perfect, and the fiscal crisis was the major manifestation of that failure. The institutions set up to respond to the crisis were crucial to ensuring that fiscal policy didn't continue to amplify the problems associated with the economic transition. For a city to turn its circumstances around, it must navigate this economic transformation, identify what will define its comparative advantages going forward, and then build anew around those sources of strength.

The road to recovery

A successful fiscal reform first requires a regime in which local officials recognize and accept the reality of the changing economic situation, and set spending budgets accordingly. This part is fairly straightforward, because it produces the simple policy dictum that borrowing—in all its forms—must be strictly limited. Of course, knowing what to do and actually getting it done are different things, especially when politics are involved. As a result, the record suggests that it can be extremely helpful to have some kind of independent fiscal monitor in place on an ongoing basis. It's important that this monitor be insulated from the direct influence of politics, giving it freedom to deliver objective analysis that may at times be very unpopular. In Washington, D.C., this took the form of the Office of the Chief Financial Officer; in New York City it is the Independent Budget Office, which is modeled after the Congressional Budget Office. These monitors have proven invaluable in keeping policymakers and the public informed on budgetary matters, and in providing apolitical expertise to assist in keeping budgets on a sustainable course.

The second major component is a successful completion of the economic transformation, which is a critical factor for reversing—rather than simply halting—a city's decline, establishing a virtuous cycle of rising growth and strengthening fiscal outcomes. New York City had the huge benefit of its comparative advantage in finance—an industry that was poised for sustained growth in the post-fiscal-crisis period of the 1980s through the 2000s. Still, the city weathered a lot of shocks during that period, including the 9/11 terrorist attacks, the financial crisis and Hurricane Sandy. It's also worth pointing out that New York City is still prospering, even though employment in its finance sector has stagnated. This illustrates the need for cities to continually look for new areas of growth, such as health care, technology, and leisure and hospitality services.

This is why PROMESA (the Puerto Rico Oversight, Management, and Economic Stability Act) emphasizes long-term growth, and why the New York Fed has been focused on identifying impediments to the Commonwealth's growth. Since 2012, we have released two major reports and several shorter analyses—most of which appeared in our Liberty Street Economics blog—presenting ideas that, if implemented, might help to make the Island more competitive and reverse its economic decline. These ideas have ranged from the very narrow and technical to the very broad—from improving the quality of Commonwealth financial reporting to bolstering growth through education and job training to build the Island's human capital.

Since I've identified managing the ongoing economic transformation as a major component of a successful plan for Puerto Rico, let me summarize a few themes on that front. Most of these feature an important role for the Commonwealth's government, underscoring the fundamental importance of getting public policy right as a means of restoring economic growth.

First, it is important to reduce the cost of doing business on the Island as a way of encouraging business growth and increasing the demand for labor. We have put forward many ideas to consider here, ranging from ones targeted at hiring—such as giving Puerto Rico more autonomy over setting its minimum wage policy—to more general ideas like streamlining regulation. One thing that we've repeatedly emphasized is the need to find efficiencies in the Island's energy industry. Commercial customers on the Island pay roughly 20 cents per kilowatt hour for electricity—nearly double the mainland average. Island residents and businesses, as you are well aware, are also burdened with exceptionally high water utility bills. It is also important to think hard about the supply of labor—the willingness of people to work, and the education and skills that they have to bring to the market. Labor supply is equally important, but less widely discussed than the demand side of the market. Labor force participation is lower at all ages in Puerto Rico than on the mainland. This is a crucial impediment to growth, and addressing it requires innovative policy options. One idea to address this problem would be to extend the Earned Income Tax Credit to Puerto Rico. In addition, the structure of the Commonwealth's tax system creates disincentives to work in the formal sector, and suggests that tax reform could produce a growth dividend as well as a more reliable source of revenue. On top of the low labor force participation is the well known and deeply concerning high level of out-migration. In addition to the lack of labor demand, it seems likely that quality-of-life concerns such as high crime rates are playing a role in these decisions. This underscores the importance of basic public service delivery and is another example of the interplay between fiscal and economic outcomes.

Another important dimension of labor supply involves the skills that workers bring to the market. Many of these skills are acquired while in school. Our research indicates that test scores for school-age children on the Island are low, suggesting that there is an opportunity for improvement in the quality of public education. One clear lesson from recent research in urban and regional economics is that the collective skills of the people living in an area are a critical ingredient for its growth prospects. Improving the education available to residents can pay large dividends over time.

I know that this list seems long, and none of issues I have raised are easy to address. Nonetheless, I am confident that Puerto Rico has started on the road to recovery. In the current environment, it's hard to see beyond the immediate crisis to a brighter future for Puerto Rico, but that has been said of other places that have come back stronger than ever. Getting the fiscal situation in order is an important first step. The factors leading up to the crisis took many years to develop, and history shows that a successful recovery from a crisis also takes time. It is important to recognize that fact and to stay the course.

Before I conclude, let me briefly discuss our new survey. Earlier this month, the New York Fed released the Puerto Rico Small Business Survey*,* which focuses on the business performance, financing needs and borrowing experiences of firms across the Island. The survey is intended to fill important knowledge gaps and flag potential economic growth opportunities for the Commonwealth. It was designed with input from partners here in Puerto Rico, and we are very grateful for their cooperation.

Key findings reveal that firms are persevering through Puerto Rico's economic crisis, though a majority reported declining revenues. Managing cash flow is a top concern, ranking above concerns about rising business costs. There is significant demand for credit, with the most common reason being the need to meet operating expenses. For about half of all small firms, credit needs were under $25,000. Lastly, about 80 percent of firms do not sell online or export their wares or services. Firms see this as a growth opportunity, ranking programs in support of increasing sales—to the federal government, via online commerce and through exports—as their top training need. We hope that the survey will provide useful insights into a key economic sector and help inform policy to support Puerto Rico's recovery.

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