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Partnership for New York City

# Earthquake on Wall Street

**Remarks to the Empire Center for NYS Policy & Center for Governmental Research Conference on Rightsizing New York's Budget**

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Thanks to E.J. McMahon, the panelists and organizations that have come together today to frame a constructive response to the budget crisis confronting New York State. I am reminded of a phrase I learned in high school Latin: *per aspera ad astra* (through difficulty, toward the stars). This year's budget process will be arduous and painful. But it could also be an opportunity to reach for a new constellation of fiscal and economic development policies. Hopefully today's conference is a step in that direction.

The Partnership for New York City is an organization of international and local business leaders. It was established in the wake of the 1970's fiscal crisis by David Rockefeller, who believed civic engagement should be part of the job description of a CEO. In the Rockefeller tradition, the Partnership has taken a practical, non-ideological approach to public policy and budget issues. We have supported expanded investment in education, affordable housing and public transit; we have advocated for an increase in the state minimum wage, congestion pricing and even some tax increases. The Partnership has frequently partnered with organized labor, most recently joining union leaders, the Governor and Speaker Silver on a trip to Washington DC to push for a federal stimulus package that will provide relief to the state.

The Partnership's core mission, however, is to tap business expertise to help the city and state frame policies and programs that promote economic growth, attract private investment and generate private sector jobs. Ultimately, broad-based economic growth is the key to generating new state revenues and eliminating the budget deficit. So I welcomed E.J.'s invitation to open today's program with some observations about how New York State's economy and budget will be affected by the global financial crisis. My remarks will not be upbeat, but neither are our economic and fiscal realities.

First, let me summarize how the business community looks at the current status of our economy. We are about one year into what will probably turn out to be a two-year, global recession that started in the housing markets, moved to the financial markets and now has infected virtually every sector. The depth and length of this recession is being driven by loss of confidence in our financial system on the part of consumers and investors around the world. In less than a year, the imputed value of US real estate, stocks, and bonds has fallen by more than $15 trillion – more than any period since the Great Depression – and no one thinks we have hit bottom. Recovery, when it comes, will not be a sharp upward turn of fortune. Instead, the American economy is likely to bump along on the bottom for some time.

However tough things are for the country, they are going to be worse for New York because Wall Street is the epicenter of the financial system collapse. For much of the last century, the robust manufacturing and agricultural producers of Upstate New York subsidized our downstate urban centers. That pattern reversed starting in the 1980's, with globalization and the emergence of Wall Street as the center of world finance. As we entered the 21st Century, the financial services industry was generating more than 25% of the total $900B economic output of the New York Metropolitan Region and surplus tax revenues from the city and its suburbs were subsidizing the rest of the state. At lunch today, Comptroller DiNapoli will say more about the enormous contribution that the industry has made to the city and state economy and tax rolls, to the health of our pension funds, and to employment across all sectors.

The crisis of 2008 has been the ultimate Emperor-has-no-Clothes moment for Wall Street. When the housing bubble burst, financial firms were stuck with large portfolios of securities which had questionable worth and that no one wanted to buy. Trading stopped, markets froze, and only the federal government – with its power to print money – could save the system from total collapse. Investment banking institutions that had leveraged their capital reserves at ratios of more than 30 to 1 did not have sufficient capital to honor all their potential liabilities and had to undertake the difficult process of de-leveraging. The result is an on-going credit crunch, as institutions are forced to hold onto every penny of capital – including the federal TARP money – to backstop the falling value of their own assets. There is also serious downsizing, with industry employment already down 20% this year.

The problems of Wall Street create serious collateral damage to other sectors of the New York economy . Our most robust sources of job growth for the past decade -- professional services, retail and tourism, and information services—all depend on clients and customers in financial services. Similarly, Wall Street has been the dominant force in New York philanthropy and in angel funding for early stage business ventures. And New York's real estate industry is most profoundly effected, both high end residential and commercial office leasing and development. Not only are lay offs and consolidations of big firms creating significant office vacancies, but restructuring of the industry suggests that large numbers of support jobs will be relocated from $80 a square foot space to cheaper places. Belt-tightening is the new mantra on Wall Street.

Of course, this is not the first Wall Street crisis to hit New York. Following the stock market collapse in October, 1987, the city lost 329,000 jobs. The terror attacks on 9/11 cost 125,000 jobs. In both cases, the jobs were fully recovered within a few years.

But this crisis is different. Wall Streeters describe this as their 100-year storm. In a matter of months, a global industry has fundamentally changed and will never look like it did just one year ago. The City Comptroller projects that $28 billion in bonuses that have helped generate tax revenue surpluses in recent years will be down 50% to $14 billion this year and decline further in 2009. The State Comptroller estimates that State revenues from the Street will be down at least $4.5 billion over the next two budget cycles.

If there is one message I want to deliver today it is that we cannot treat what is happening in New York as a normal recession or a cyclical downturn. It is not. It is structural. The highly leveraged investment-banking business model is gone, and the huge profits and inflated payrolls of Wall Street have gone with it. A permanent downsizing of the industry is underway and New York City may lose as many as 250,000 jobs from the industry and its multipliers by 2012. New York is emerging from this crisis with a profoundly different economic profile than we went in with.

There are three primary factors that distinguish this from past downturns:

- First is the sheer scale of the damage to the institutions that made New York the world financial capital. It started just about six months ago, when Bear Stearns blew up and was acquired for pennies on the dollar by JPMorgan Chase. Lehman Brothers, having survived 100 years of market ups and downs, was wiped out – with Britain's Barclays and Japan's Nomura Securities picking up the pieces. Wachovia – which had established a strong New York presence by acquiring Fleet Bank and Prudential Securities – has dissolved into California-based Wells Fargo.

Merrill Lynch became the property of Charlotte-based Bank of America – and anyone who doubts that this is a new world just has to ask a Merrill Lynch banker what they think of BofA's compensation structure. Citi – which had long been New York City's largest private sector employer -- has laid off 78,000 people worldwide. Goldman Sachs and Morgan Stanley – the last major American investment banks left standing -- converted to federally regulated bank holding companies. AIG, while still strong in insurance, went bankrupt as a result of its credit default swap business. Our credit card issuers and hedge funds are standing by, waiting for the other shoe to drop. In short, the industry is already a shadow of its former self and the crisis is still running.

- The second new reality is that the U.S. banking industry has been effectively nationalized, with the federal government becoming a partner in every major firm. All nine of the large TARP recipients are members of the Partnership for New York City – illustrating the concentration of rescue activity in New York. As part of their investment agreement, the Federal government has mandated restrictions on executive compensation and prohibitions on risk-taking. The result will be lower profits and a less aggressive, less innovative posture for US firms in the global marketplace. It will also mean significantly lower tax revenues for New York City and State.

- Finally, over the next year, it is certain that Congress will put in place a new financial regulatory system. It will focus on risk aversion, rather than competitiveness. This system will not allow the kind of leveraged financing that made investment banking so lucrative. The new regime will also extend regulatory controls to hedge funds, asset managers and the whole array of small and varied financial firms that have previously existed outside the system and contributed to the depth and wealth of New York's industry. Foreign Direct Investment may also suffer in a new regulatory environment. A Partnership study has documented that FDI represented 9% of our state economic growth over the past five years. One in 20 NYC workers is employed by a foreign company, mostly in financial services. A change in the regulatory environment may make the US less attractive to these companies and dilute what has been a critical source of economic activity and jobs for the state.

Despite these challenges, among the survivors on Wall Street and the leaders of the Partnership there is confidence in the long term future of New York so long as government and business take the right actions in response to the current crisis. Financial centers around the world are suffering through the same problems, so we are not losing ground in a competitive context. London is as worried about the dampening effects of the regulatory regime coming down from Brussels as we are about Washington. New York's buzz and its attraction to young people, professional talent and to foreign investors are temporarily diminished but still strong.

What do we need to do to reclaim our position as a leader and resolve our fiscal and economic challenges? Here are a few abbreviated suggestions:

- New York should be first in line with great ideas for securing and deploying proceeds of the Obama economic stimulus package.

- We should support our financial services industry as it regroups and seeks to restore confidence in the financial markets and end the credit crunch. We have opportunities, in financial technology and in the insurance sector (which remains a bright spot in the financial services industry) to lead the next generation of innovation and maintain our international pre-eminence.

- We must reform our broken economic development programs and create a comprehensive plan for reviving the entire state economy. We need new, highly targeted incentives to attract high wage, private sector jobs and to create regional clusters of economic activity in high tech industries. In addition to financial services, energy and green technology, nanotech, biotech and life sciences are all areas where New York State has competitive advantage that can be leveraged into job creation and business development.

- We need to revise our state tax structure, simplifying the business tax regime and aligning tax policies with a contemporary model for economic growth.

- Finally, we need to maximize our state assets – both in terms of reform of our procurement and contracting for infrastructure maintenance and development along the lines being advanced by the Governor's commission on this topic – and through incentives for universities and business research and development operations to collaborate and commercialize their ideas within the state.

To figure out how to move forward, it's useful to look back at how we got here. Over the past decade, housing prices rose three times as fast as household income. Americans were living off credit cards and the proceeds of home equity loans that were predicated on ever-rising housing values. By 2007, the American consumer debt to income ratio was at an all-time high. The bubble burst and so began our first-ever, consumer-driven recession.

Throughout this period, New York State government was doing exactly the same thing as the American consumer -- piling up debt, surviving on non-recurring revenues, living beyond its means. The financial services industry, which experienced huge growth in its size and profitability as it led the city and state into the global economy over the past two decades, was simultaneously an enabler of state government's excesses. Without its profits and bonuses, New York State has no choice but to restructure its expense budget and reform its economic development policies. It is time to chart a new course – one where future headlines proclaim New York's prominence as a diversified high tech, high wage state that remains America's gateway to the global marketplace.

The lesson I learned high school Latin is useful today. It is the budget this year that is the difficulty we must get through. And it is the new economy we must build that can take us, if not to the starry heavens, at least to a better place than we are today. The Partnership looks forward to working with you to meet this challenge.