A Walk Around the World Economy

Remarks before the Joint World Affairs Council/Dallas Friday Group

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The views expressed are my own and do not necessarily reflect official positions of the Federal Reserve System.
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Ray Hunt reminds me of a saying that was drilled into us at the Naval Academy, known as John Paul Jones’ Creed, after the Father of the United States Navy. According to that Creed,* high among the attributes of true leaders were a habit of “punctilious courtesy and the nicest sense of personal honor.”

I have known Ray Hunt for more than 30 years, and he has those attributes in spades. He is possessed of punctilious courtesy and the nicest sense of personal honor, which is why he is so respected by everyone in this great community.

I want you to note, however, that hyperbole was not an attribute Jones ascribed to leaders, Ray. So I am going to ask this wonderful audience to apply a huge grain of salt to the nice things you just said about me.

It is an honor to be the President of the Federal Reserve Bank of Dallas in significant part because I get to serve a board of directors led by Ray Hunt and whose vice-chair is Pat Patterson, the Chairperson of the World Affairs Council, and a woman whose commitment and enthusiasm for the Dallas Fed are legendary. Thank you, Pat, for all you do for us and for inviting me here today to give my maiden speech as President of the Bank.

I see so many friends in this audience, members of the World Affairs Council and the Friday Group. If you will forgive me singling just one of them out, I want to acknowledge my mother-in-law, Dee Collins Torbert, one of Dallas’ most thoughtful and generous citizens.

Unlike most sons-in-law, I can honestly say that Dee is one of my all-time favorite and best friends. We have lunch every Sunday and enjoy the symphony together.

How lucky I am not to be like the Irish farmer Murphy, whose mother-in-law suffered a mortal kick from his mule. When Father O’Donald looked over the great congregation of mourners at her funeral, he was taken aback.

“Murphy, just look out there, my son. There are over a hundred husbands here. I had no idea your mother-in-law was so beloved.”

“Father,” Murphy replied, “they are here to buy the mule.”

Mother, I am delighted that you are here today. I wouldn’t let a mule come within 50 miles of you.

The CliffsNotes Tour d’Horizon

This speech was billed as “A Walk Around the World Economy.” That could take all night, and I have some other matters I would like to have you think about. So if you will allow me, I am going to give you the CliffsNotes version of today’s global economy.
Let’s start with Canada, the Rodney Dangerfield of countries. A pundit once described Canada as the vichyssoise of nations—cold, half-French and difficult to stir. But as an old trade negotiator, I like to remind people that our neighbor to the north is a dynamic economy and our largest trading partner. The two facts are interrelated. Canada has been doing quite well in no small part because of the demand pull of U.S. consumption.

Mexico, which I call the salsa of nations, continues to improve economically—for much the same reason as Canada. It is no small wonder, as Mexican industrial production is 90 percent correlated to growth in U.S. GDP. Remember the immortal words of Mexican leader Porfirio Diaz: Pobre México: tan lejos de Dios y tan cerca a los Estados Unidos. I grew up in Mexico, and I know the country well. While the Mexicans are not all that far from God, they certainly are joined at the hip with the United States—to our great mutual benefit.

The rest of Latin America confounds. Brazil is doing well in feeding global demand for raw materials and some first-rate high value-added products, like aircraft and computer peripherals. Chile continues to zoom along as the most free-enterprise-oriented economy in the southern part of our hemisphere. Colombia still defies the odds given it by the ill-informed observers who stereotype the country solely as a base for narcotraficantes. The rest of Latin America lags. One has to wonder what will happen when the boom in commodity prices abates.

Rotating to Africa, we encounter heartbreaking circumstances. The 48 sub-Saharan economies are riddled with warlords, dictators, inefficiencies and misery, and they remain economic disappointments. The one exception, South Africa, is entering the globalized market with sophistication and moxie.

As for the Middle East, well, you know the story. The oil base of this region sustains it, and there is a titanic exercise under way regarding political structures about which I can add nothing insightful.

Europe continues to disappoint economically, with Germany experiencing unemployment rates not seen since the 1930s, France unable to break out from anemic growth, and Italy teetering on the verge of recession. Driven by a switch to a more market-based system, Spain has been robust over the last decade. The “New Europeans”—the former satellites of the Soviet Union—are presently the darlings. Latvia, for example, where the President this last week began his current tour, is growing at a rate of 8.5 percent.

Were it not for exports, Europe would be in dire straits. Germany is the only major industrial country to have steadily increased its share of world exports during the past five years—now up to 9.4 percent. In doing so, it chalked up a $136 billion trade surplus, 56 percent greater than Japan’s, despite a 50 percent appreciation in the euro.

I won’t say much about Russia, where yesterday President Bush celebrated the 60th anniversary of the end of World War II. Despite its enormous energy resources, Russia has an economy roughly the size of New Jersey’s in dollar terms. It continues to migrate from a kleptocracy to we know not what.

Japan, the world’s second largest economy, continues to frustrate. It has fought both recession and deflation for more than a decade. Like Germany, Japan has been buoyed by its export sector as it grapples with domestic economic reform. I have lived in Japan and as Deputy Trade
Representative negotiated for four years with the government there. It has a unique economic pathology, which we might discuss during the Q & A period.

I’d be remiss in my thumbnail tour d’horizon if I failed to praise Britain—which, thanks to the Thatcher Revolution and Tony Blair’s “third way,” has continued to thrive. Indeed, it is fair to say that the stalwarts of the former British Empire—Britain itself, the United States, Australia and New Zealand—stand out as exemplars of economic success during an otherwise tough period for the world economy. Ireland is the real star of the British Isles, growing at an average annual rate of 6.1 percent over the past five years.

More than ever before, we are focused on China and India, which have startled the world with their economic successes.

I want to dwell on China for a second. As Ray mentioned, I was part of the team that negotiated China’s entry into the World Trade Organization, helping to bring them into the fold of the global economy. We did this at the instruction of the President of the United States and, let me emphasize, the approval of the Congress. But two decades earlier, I had been lucky to witness the first stirrings of the Chinese economic revolution, firsthand.

In 1979, I was the youngest member of the U.S. delegation Jimmy Carter sent to China to settle the claims left after Mao’s government seized the railroad rolling stock we had lent Chang Kai-Chek. Nixon—or Kissinger, as we say in the firm I used to work for—had normalized political relations in the early 1970s. But it fell to Carter to normalize economic relations and finally raise the flag on the U.S. Embassy. So we could begin to trade with each other and get on with a normal relationship, Secretary of the Treasury Mike Blumenthal was sent to negotiate with Deng Xiaoping. I was Blumenthal’s assistant, so I accompanied him to all his meetings with Deng.

I will never forget our first meeting with Deng. He was electric. You may remember he was a short fellow—about 4-foot, 8-inches, if memory serves. But he was a giant of a man with big dreams. In our first meeting, he entered the room and cackled, “Where are these big American capitalists I am supposed to be so afraid of?” And then he went about laying down his vision of driving China down “the capitalist road,” a plan that he did not proclaim publicly until years later.

Deng told us then that he would unleash the Chinese genius, and focus it on development and modernization. To him, when it came to ideologies, it didn’t “matter whether the cat is black or white as long as it catches mice.” And mice they have caught in droves. Since 1979, China has grown at better than 9.4 percent a year. If you do the math, that adds up to an almost tenfold expansion of the economy. Last year, China chalked up another 9.5 percent growth rate, defying the pundits who for years have projected a sharp slowdown. Since Blumenthal’s meetings with Deng Xiaoping, China has moved more than 300 million people out of poverty.

Capitalism is a brilliant thing.

I am convinced that India would not have gotten on the ball if it were not for the example of China. India has been growing at a 7 percent clip, though for a shorter time. It has some disadvantages that China does not suffer from—a lack of gender equality, an underdeveloped educational system for the masses and the lingering problem with castes. But it has some enormous advantages in addition to a colonial legacy of widespread use of English, foremost among them a respect for intellectual property and the rule of law.
When it comes to China and India, I ask you to think beyond the headlines—beyond the hype—and keep their burgeoning economic miracles in perspective. Measured in dollars, the economic output of China is roughly that of one U.S. mega-state, California. India’s economy is 20 percent smaller than that of Texas.

As fast as China and India are growing, these two countries have a long way to go before they overpower the United States, as some alarmists claim they will. We are a $12 trillion economy. Let’s do the math together. Pick a number of, say, 3 percent for real U.S. growth—well within our recent experience. Just to match the dollar value of our annual increase in production, China would have to grow 21 percent. India would have to grow 56 percent.

That said, it is true that they are growing like “gee whiz”—thanks, to a great extent, to U.S. consumers of goods and services. China’s exports to the United States have doubled since we inked our bilateral World Trade Organization deal and by 1,600 percent over the past 15 years. India has become a major information technology and business-processing center for U.S. companies, and jobs are shifting to Bangalore from Baltimore and to Delhi from Dallas.

You may have noticed a recurring theme in what I have said tonight. Trade underwrites global economic growth—exports to the United States in particular.

We buy $1.9 trillion a year in goods and services from the rest of the world—16 percent of our GDP. We sell $1.2 trillion to other countries.

Once again, some simple math will put this in perspective: Each year, we buy more from abroad than the entire French or Chinese economies produce; what we sell overseas exceeds the total yearly output of the economies of all but six foreign countries—and one of them is California!

America is a mighty economic machine.

In my book, there are some cardinal reasons why this is so. I want to focus on two of them: first, our willingness and ability to compete in the global marketplace rather than erect barriers to competition; and second, the blessing of having a central bank—the Federal Reserve—that is independent and free and conducts itself with a steady hand.

Protectionism Is Our Enemy

The competitive spirit is part of the American DNA. We shine when we face up to the challenge of vigorous competition.

And we benefit from it.

Which is why, under both Republican and Democratic Presidents, we pursued trade liberalization hammer and tong in the 1990s.

Well beforehand, the case for competition had been well articulated—by such economists as David Ricardo, of course, and by enlightened political leaders. Among free-trading politicians, two of my favorites are Winston Churchill and Grover Cleveland.

If you ever want to read a brilliant exposition of the case for free trade, go back to speeches given by Winston Churchill from 1905 and 1906. He railed against trade barriers, even when the nations from which Britain imported were unfairly subsidizing their goods and services!
Churchill preferred for other countries to cheat their taxpayers by doling out money to their pet industries, rather than have the British government do it. He even spoke out against laws that would prevent dumping into the British market. His remedy for the inevitable import headaches: to move up to what he called “the superfine processes.” Britain would take cheap imports from abroad and use them as inputs into higher-value-added products, thus capturing larger profit margins, creating better quality jobs and moving England up the economic ladder.

More than a decade before Churchill, President Cleveland understood the magic of tearing down American barriers to competition from all comers. In his third address to the Congress, he characterized tariffs as “a vicious, inequitable, and illogical source of unnecessary taxation ... which imposes a burden upon those who consume domestic products as well as those who consume imported articles, and thus creates a tax upon all the people.”

Cleveland knew full well that foreign competition harms some industries and certain workers. He also understood the greater truth—that imports untaxed by tariffs and non-tariff barriers are not poison for the overall economy. They are a tonic, an incentive. Bargains from foreign lands lower the cost of living. When consumers pay less for clothes, shoes and, today, electronics, they have money to spend elsewhere—to the benefit of local businesses.

Cheaper inputs help American producers lower their costs. Just as important, foreign competition forces U.S. producers to cut costs and bolster efficiency, providing a spur to productivity. We thus pave the way to move up to the “superfine processes,” like bio- and nano- and the higher reaches of technology. They will keep us at the forefront of the global economy and allow business to do what it does in a capitalist system, creating jobs and profits that in turn lead to more jobs and profits in a virtual cycle that, properly nurtured, goes on indefinitely.

To be sure, India and China are going to be tough competitors. The current issue of Newsweek has a cover story on China. It raises the question: How to handle China? And it provides a juicy punch-line answer, which I will quote verbatim so as to stay out of trouble. These are Newsweek’s words, not mine: “The best guide (on how to handle China) is to listen to what French President Jacques Chirac says and do the opposite.”

President Chirac is advocating the reimposition of textile quotas to ward off Chinese imports. Similarly, leaders in the German parliament are railing against “foreign locusts” and immigrant labor.

History tells us you cannot survive if you withdraw into your shell. You must compete to stay fit. Erecting barriers to competition through protectionism is risky behavior that may please some special interests momentarily but is certain to lead to economic decline over the long term.

As Ray mentioned, I spent four years managing trade relations under NAFTA, crafting the architecture for the Free Trade Area of the Americas, and helping negotiate trade agreements with Japan, Korea, Australia, Taiwan, Vietnam and the big daddy of them all, China’s accession to the World Trade Organization. I have heard every argument AGAINST free trade and in favor of protectionism. They all ring hollow.

Freer trade with able competitors is a plus for the American economy, not a minus.

Let me illustrate the point with a few numbers that cover the time since I left Dallas at the end of 1997 to go to Washington.
Prices for goods not subject to foreign competition have risen since 1997: college tuition and fees, up 53 percent; cable and satellite television, up 41 percent; dental services, up 38 percent; prescription drugs and medical supplies, up 37 percent.

But prices of goods subject to foreign competition have fallen over the same period: by 86 percent for computers and peripherals, 68 percent for video equipment, 36 percent for toys, 20 percent for women’s outerwear, 17 percent for men’s shirts and sweaters.

This is because of the work of two presidents, a Republican and a Democrat, who opened wide the doors to trade. Presidents Bush and Clinton understood that reducing tariff and non-tariff barriers served as tax cuts for American consumers and producers.

And as a stimulant to growth.

Our economy has grown 3.3 percent a year since 1994, when we ratified the so-called Uruguay Round of trade liberalization and passed NAFTA through Congress. Despite a recession in the early years of the decade, we have added nearly 17 million jobs by moving up the value-added ladder into increasingly “superfine” businesses. No other major industrialized country matches our overall economic performance during the recent decade of rapidly rising imports. No one—not England, nor Germany, nor Japan, nor France.

The Business of Central Banking

The benefits of freer trade dovetail nicely with the work of the Federal Reserve.

Price stability is a central banker’s sacred charge. Imports have greatly facilitated the job of the Federal Reserve in keeping inflation at bay and in the neighborhood of 1 percent to 2 percent during recent years. Indeed, prices tamed by competition gave monetary policymakers greater leeway to err on the side of economic growth; it facilitated the “accommodation” of recent years that has kept the economy growing without inflationary consequences.

Will Rogers once quipped that “the three greatest inventions of man were fire, the wheel, and central banking.” At the time, shortly after the failure of the Bank of the United States and the onset of the Great Depression, he was being sarcastic. That said, the idea of an independent central bank like the Federal Reserve is, I think, an ingenious invention.

The great novelist Henry James didn’t leave behind any memorable quotes on central banking, but he wrote one of my favorite passages in literature: “Courtship is poetry, while marriage is hard prose.” I hope you’ll let me twist it a bit to make some points about the work of the Federal Reserve.

The poetry—the romance of the Federal Reserve—is, in the eyes of the press and the pundits, the deliberations of the Federal Open Market Committee, which manages the money supply and sets the targets for the Federal Funds rate.

Far less newsworthy but equally important is what I refer to as the “factory side” of the Fed. Therein lies the hard prose—the hard work of thousands of dedicated professionals who work to facilitate the efficiency of the economy’s financial side.

The Dallas Fed, for example, will process nearly 1 billion checks this year for the banking system. We supervise the banks chartered in our district, which covers all of Texas and parts of
Louisiana and New Mexico. We process currency that moves through a sprawling district that, if it were a country, would be the 12th largest economy in the world. (If you ever need to do your laundry or park at a meter, call me. We have more than 150 million quarters in our vaults.)

And, like the other 11 Federal Reserve banks around the country, we do serious economic research to inform monetary policymaking. The quality of our research is tops. Few of you might know, for example, that Finn Kydland, an associate of our research team in Dallas for the past 13 years, won the Nobel Prize in economics in December. If he weren’t a Norwegian, and genetically humble, I am sure he would be a social darling of this great city.

I have ambitions for our research team. We announced them last Thursday.

The Dallas Fed has been at the forefront of understanding the impacts of NAFTA and immigration on our free-enterprise economy. Our economics team instinctively understands what it means to operate in a porous and open economy, like we have in this state. They are therefore well positioned to understand what will happen to the entire United States as its economy becomes more porous and open to competition from China, India and other new entrants onto the global economic stage.

This new setting challenges conventions held by economists for a long, long time—ideas such as the so-called “Phillips Curve” that once defined the trade-off between unemployment and inflation; the amount of slack or tightness in the economy; and the gaps that might exist between actual and potential output.

If we have been able to understand these relationships in the world’s 12th largest economy, we ought to be able to assist the Federal Reserve System and the economics profession with understanding how they will change for the largest economy in the world. In the end, we hope to better inform monetary policy. And so last week, we appointed Harvey Rosenblum, a great economist, to lead this effort.

So that is the hard prose.

Now let’s get back to the poetry of monetary policy. Think of the Federal Reserve as a pacemaker regulating the heart, which pumps life-giving blood through the body of the economy. It is an epic undertaking. The job of the Open Market Committee is to provide just enough flow to keep the body growing without giving rise to the destructive virus of inflation.

Doing so requires precise skill. We know markets are manic-depressive mechanisms, given to extreme mood swings. Warren Buffett, the “Sage of Omaha,” captured these ups and downs by introducing us years ago to a fellow named “Mr. Market.” “At times, Mr. Market feels euphoric and can see only the favorable factors affecting . . . business. At other times he is depressed and can see nothing but trouble ahead for both . . . business and the world.” Buffett was referring to the stock market, but this is true for all markets, be they for stocks or bonds or foreign exchange or futures markets or homes or baseball cards.

My favorite recent example occurred on April 29, when the markets went apoplectic after the Chinese currency moved just 6 one-thousandths of a yuan from its pegged rate of 8.277 to the dollar. (It may be true that economists put numbers to the right of the decimal point to show they really do have a sense of humor.)
We know the markets are given to volatile behavior. It is the very nature of the beast. In this kind of environment, the Federal Reserve has to keep an even mood and a steady hand.

The Chairman of the Federal Reserve and the 18 other participants on the Open Market Committee understand the need to conduct their deliberations and their actions in a manner that does not surprise the markets or exacerbate the natural proclivity of markets to mood swings. At last week’s meeting, for example, we were well aware of the pessimism rampant in the marketplace about the pace of the economy and rumors about the return of “stagflation.”

I’ll use a baseball analogy—as a salve for those who had tickets to the Rangers game against the Tigers tonight but felt obligated to come here instead for the musing of a rookie central banker.

Having gotten used to standing at the plate and seeing fastballs of 4 percent economic growth thrown right down the pipe into a strike zone of 1 percent to 2 percent inflation, the data being pitched the past quarter to the FOMC included some change-ups and knucklers in the form of reports of a slowdown of consumer spending, sluggish wage increases and flaccid business investment. The fans—the financial markets—were getting antsy.

The Open Market Committee stood straight in the batter’s box and did not allow itself to get frazzled. After looking at the data and considering the tenor of the markets, it was the considered judgment of the Committee to stay the course by continuing to tighten policy “at a measured pace.”

The jobs data released on Friday showed that the U.S. economy created 274,000 jobs in April and that participation rates, productivity, hourly wages and average workweek had all risen for a second straight month. These readings may allay some fears about the wisdom of our decision.

Conclusion

The night is late and all good things must come to an end. I would be happy to answer any and all questions, Mr. Chairman.

However, I have been forewarned that I might be asked, once again, if I am a “hawk” on inflation or, like my distinguished poetry-writing predecessor, Bob McTeer, a “dove.”

As a diplomat, I used to invoke what I called the Ustinov rule when asked questions. The British actor Peter Ustinov used to say: “I am convinced there’s a small room in the attic of the Foreign Office where diplomats are taught to stammer.” Pressed to divulge secrets of trade negotiations, I would resort to the Ustinov rule and develop a pronounced stammer.

As a Federal Reserve official, I might now evoke something similar, called “Fedspeak,” perfected by Chairman Greenspan but whose patron saint, at least in my book, is the former baseball great Casey Stengel. The Yankees manager was summoned in 1958 by the Senate Antitrust and Monopoly Subcommittee, and Senator Estes Kefauver interrupted him after a rambling, evasive effort to avoid answering a question. “Mr. Stengel, I am not sure that I made my question clear.” To which the cagey Casey replied: “Well that is all right. I am not sure I am going to answer yours perfectly either.”

Or I might fall back on the Dallas Fed’s tradition of poetry, which I will do now to preempt the “hawk” or “dove” question.
My Dallas predecessor
Aspired to be a dove
While others making policy
Were hawkish from above.
But this aviary naming
Invokes improper fowl
For I'd rather be remembered
As a wise, and thoughtful, owl.
Thank you.

*John Paul Jones’ Creed, it turns out, was invented by an imaginative historian.