A Perspective on the Economic Outlook

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I am honored and delighted to speak to this Greater Dallas Chamber Economic Forum. Today marks the six-month anniversary of my return home to become president of the Federal Reserve Bank of Dallas.

William Gladstone, Britain's prime minister four times in the 19th century, once observed that "Not even love had made so many fools of men as pondering over the nature of money." Yet, that is what I am paid to do!

And there is no better place to do it than here in Big D. As mentioned, I left Dallas in 1997 and wandered in the wilderness of Washington for eight years. I spent half the time as a roving ambassador negotiating trade agreements in Asia and Latin America and with our NAFTA partners. The other half I spent working with Henry Kissinger and former White House chief of staff Mack McLarty, advising corporations on their business strategies overseas. It was all very exciting, but I am glad to be home—home to genuine people, the best Mexican food, great barbecue and real football.

I traveled to College Station this weekend to watch the Aggies eke out an overtime victory against the Baylor Bears. Before watching those two teams from storied Texas universities go at it hammer and tongs, I spent a couple of hours with the Aggie Corps of Cadets. After the game, I heard that the Texas Longhorns had walloped Missouri. The day reminded me of the magic of Texas: This is a can-do place, unafraid to tackle any problem or confront any competitor.

I want to talk to you today about the economy and about confronting problems—both homegrown and deriving from international competition—that loom on the horizon.

Let's look first at the Texas economy.

Our state's economy is a big one. I'll give you one number that puts the size of the Texas economy in perspective: In dollars, our 22 million people produce 21 percent more than the 1.1 billion people of India. We produce more than Spain, South Korea, Indonesia and Australia. What happens here influences the global economy.

Texas took its time coming out of the most recent recession. With a concentration of activity in high technology and especially telecom—particularly in North Texas—we did not shake free of the doldrums until mid-2003. Since then, we've added 307,000 jobs, capped by steady and broad-based employment growth this year.

Like the 11 other Federal Reserve Banks, we produce a report called the Beige Book, a compendium of firsthand observations on our district's economy. Before Hurricane Katrina hit, the Beige Book showed Texas pumping on all cylinders, including the high-tech sector. Energy and construction markets were booming, and labor markets were continuing to strengthen.

Then Katrina, the mother of all storms, hit the Gulf Coast and New Orleans, followed in short order by Rita. These two powerful hurricanes have been devastating for the region, and we, like all Americans, have been shocked by the heartrending destruction they wrought.

From an economic standpoint, Katrina and Rita have left their marks on Texas. Some state firms lost inventories. Others lost customers that were in the supply chain for the impacted area. The state budget has also taken a hit. A total of 265,000 evacuees fled to Texas, and many have no home to return to. More than 45,000 evacuee students have enrolled in Texas public schools—about 1 percent of total Texas enrollment. Another 10,000 to 15,000 students may be in the pipeline. The fiscal burden for evacuees in public schools could be $335 million to $432 million, assuming the evacuees remain in Texas for the entire school year.

Other negatives for Texans include increases in the costs of doing business. Rebuilding efforts will push up prices for construction materials. Many industries are likely to encounter higher fuel, freight, utility and transport costs—a heavy burden for those sectors, like airlines, already facing hardships. Consumers will have to pay more for winter heating bills and possibly gas at the pump, so they may have less to spend at retail stores and restaurants.

Yet, even with these drags on the economy, it appears that the hurricanes' net effect will be slightly positive for Texas. Several sectors of the economy will actually benefit from the storms. For example, Katrina hit at a good time for Texas apartment markets. Vacancies were high, and Houston and Dallas were among the weakest apartment markets in the country. With the influx of evacuees, occupancy rates have shot up in both major metropolitan areas. The Houston office market, which was firming already, got a slight boost as well. Katrina also bumped up demand for hotel rooms, a market that was already improving. And there are reports of energy and law firms moving temporarily to Houston after Katrina.

The housing market continues to be strong across the state. We've led the nation in housing starts this year. Texas homeowners have not experienced the kind of rapid real-estate price appreciation seen in the Northeast and California. As a result, a break in the rise of national home prices—should one occur—poses little downside risk in Texas. Being an also-ran in the home-price derby could, in fact, be an advantage: Rapidly rising home prices elsewhere have made our region a more attractive place to locate businesses and their workers. A number of business leaders tell us they hope some of the skilled workers and professionals from New Orleans might become permanent Texas residents.

In short, while Katrina and Rita will cause some problems in Texas, the state economy is strong and resilient enough to cope with them. Dallas Fed economists expect the Texas economy will continue to grow and may well accelerate in the aftermath of the storms. The challenge for Texans, as always, will be to turn adversity to advantage, something we excel at.

The National Outlook

The national economy faces the same challenge—and more. The United States occupies a unique space in the world, producing more than $12 trillion a year in goods and services, a total exceeding the combined economies of Japan, India, China, Germany and Great Britain. Our prowess goes beyond sheer bulk. It derives from our flexibility and competitiveness. You may have read recently that the World Economic Forum ranks the United States the world's second most competitive economy. Finland was ranked first. I'll pocket that. Finland has a great economy—but it does not even measure up to Connecticut in size.

In terms of the outlook, the data present a less than clear picture. We are dealing with the immediate and secondary effects of Katrina and Rita, doing so in a period with natural gas at nearly $14 per million BTU. In times like this, the Federal Reserve must rely, more than ever, on anecdotal evidence to get a feel for the economy. Since becoming Dallas Fed president in April, I have spent many hours talking with CEOs, COOs and CFOs here and nationwide to get the latest information on trends in the economy. In the days before the Sept. 20 FOMC meeting, I doubled the time devoted to such calls. And the Dallas Fed research staff did additional surveys of its key business contacts as well, trying to ensure up-to-date readings.

We heard that the pace of economic growth had begun to slow slightly prior to Katrina and that the disruptions from Katrina, and later from Rita, would initially slow growth a bit more. The U.S. economy grew at a 3.3 percent annual rate in the second quarter. Now, most forecasters anticipate growth closer to 3 percent in the fourth quarter. Many of them expect the bounce back from rebuilding the Gulf Coast to begin in early 2006, though the impact will be spread over several years. In the past, this pattern has repeated itself for a wide range of shocks and natural disasters. The one common element has been the resilience and flexibility of our free market economy.

Before Katrina and Rita, higher energy prices had begun to exact a toll on many consumers and businesses. Much of the Federal Reserve's monetary policy accommodation had been removed. Many homeowners with adjustable-rate mortgages tied to short-term interest rates were about to have their mortgage rate reset. And sales of automobiles and light trucks were bound to slow after an incentive-induced summer surge. These factors help explain why the national economy appeared to be transitioning to a phase of slower growth.

More recent data on consumer sentiment, personal income and consumption confirm a slowing trend. The personal saving rate has been negative for the past three months, a not particularly encouraging development for consumers' future purchasing power.

Inflation has been on a slight upward tilt the past couple of years. Now, the inflation rate is near the upper end of the Fed's tolerance zone, and it shows little inclination to go in the other direction. We now face higher energy prices and businesses' desire to pass the increased costs on to their customers. Combine the energy spikes with spending increases by governments at every level in the aftermath of the two hurricanes—John Maynard Keynes seems to be the patron saint of both liberals and conservatives these days—and you have new demand pressures added to the old ones.

The FOMC has taken note of the fiscal situation, as shown by this pre-Katrina passage from the released minutes of the Aug. 9 meeting: "Few signs were evident that greater fiscal discipline in the budget process would emerge any time soon."

Globalization and Fiscal Policy

In this environment, the markets, if left to their own devices, would produce higher interest rates to ration money and balance the demand and supply of capital. If the Federal Reserve were to resist the upward pressure on interest rates, it would in effect monetize the burgeoning fiscal deficits. The Federal Reserve has staunchly resisted monetizing deficits for more than a quarter century, and I feel strongly that it can ill afford to monetize them today.

Let me explain why.

We live in an interconnected, fluid and rapidly changing economy. I plead guilty here, at least in part, having served on the negotiating teams that brought China, Vietnam and other new entrants into direct competition with the United States. We now do business in an intensely globalized economy, one in which the United States thrives. We have used the heightened competition of globalization to sharpen our wits. We have outgrown and outshone all the other major economies, as the World Economic Forum studies on competitiveness have shown. But we must not be complacent. We have to keep ahead of the competition. To do so, we must better understand and exploit globalization.

Five years ago, Chairman Greenspan told his colleagues at the FOMC that Information Age technology had begun rewriting the operations manual for the economy. "We really do not know how this systems works," he said. "It's clearly new. The old models just are not working."

I believe the same can be said of globalization today: We really do not understand how globalization works. China did not enter into the world economy in force until 2001. India is only now getting on the stick—as are Poland, Vietnam and other sizeable countries heretofore off the economic map. My first decision upon joining the Dallas Fed was to direct our formidable research department to study globalization's impact on the economic gearing of the United States and its consequences for monetary policy. We have only just begun to scratch the surface of what globalization really means, but we are already starting to form some conclusions.

One conclusion involves the strong connection between globalization and fiscal policy. In a world of porous borders, factors of production—people, companies and capital—are highly mobile and will migrate toward nations where they can work together most efficiently, flexibly and securely. They abhor corruption and ill-defined property rights, which act as hidden taxes on productive and creative activities and increase the uncertainty of already risky endeavors. They avoid bureaucratic restrictions that artificially lock them into outmoded methods and organizations and limit their ability to adapt to a rapidly changing economic environment. They recognize the importance of a well-maintained transportation and communications infrastructure. In short, they look for an environment with the fewest obstacles to success.

Onerous taxation is considered one such obstacle. In a world where capital moves across borders more freely than ever, globalization heightens tax competition among nations, just as it does among states in this country. Indeed, we are seeing the average tax rate come down in the world's most open economies as nations compete for productive resources. Estonia, for example, has instituted a flat tax. Poland and Germany are in the midst of tectonic electoral battles in which the extent of tax reduction looms as a key issue. And China rarely, if ever, actually collects significant taxes from the corporate sector.

Hold that thought.

Now, consider the monetary angle. Business is risky enough without the additional uncertainty created when a nation's unit of account—in plain language, its money—is undermined. Open financial markets allow investors to seek countries with stable money and shun those places where the value of their capital will be eroded. A clear result of globalization, in my opinion, has been inflation rates converging at lower levels in the competing economic spheres of North America, Asia and Europe. When it comes to accommodating inflation, central bankers everywhere have become, to quote my late, great father-in-law, Jim Collins, "tighter than a new pair of shoes."

Now, how do these two forces—tax competition and inflation intolerance—come together to impact monetary policy and my role in "contemplating the nature of money" on the Federal Open Market Committee?

Start with the premise that from time immemorial any central banker worth his or her salt has been genetically unable to tolerate inflation. This inclination is now reinforced by competition from central bankers worldwide. Next, consider the reality of tax competition. The fiscal authorities must place a minimum tax burden on capital. At the same time, they have to reassure markets about their country's fiscal soundness in a global marketplace intolerant of sloppy government budgets.

When governments run massive deficits, markets worry about two of three possible outcomes.

The first is that taxes would eventually be raised to pay for spending and move the ledgers toward balance. Higher taxes, of course, would send highly mobile capital scurrying to more tax-friendly destinations, destroying investment and jobs as it left.

The second is that the central bank would monetize the deficit, inflating the economy. The risk would be capital flight to destinations where the purchasing power of capital is better preserved. Here, I want to make myself perfectly clear: As a member of the FOMC, I will never vote to monetize fiscal profligacy. And while I never speak for my colleagues, it is my distinct impression that none of them will do so either.

So this leaves a third option: better calibrating and configuring government spending programs. In a globalized world, nations must tax and spend more prudently than ever. Just to retain capital, yet alone attract more, they must offer taxpayers the best deal at the lowest price. No government anywhere in the world can go on taxing and spending as if it is still operating in yesterday's economy. If the United States is to remain an economic colossus, its fiscal authorities, like its central bankers, will have to become paragons of prudence and restraint, implementing policies that will put the nation in a position to bolster, not hamper, its competitive edge.

I mentioned I spent the weekend in College Station. One of my favorite Aggies and I stayed up late Friday night debating a philosophical matter. I couldn't understand his argument. Finally, in frustration, he blurted out what he said was Aggie Latin: " Bubbus, sed possum explicare. Non sed possum comprehendere."

"What the hay does that mean?" I asked.

"What it means," he said, "is: 'Bubba, I can explain it to you. But I can't understand it for you.'"

As the months and years go by, my colleagues at the Dallas Fed and I will do our utmost to explain the impact of globalization on the Texas and U.S. economies and on monetary policy. We trust you will do your best to understand it and, with characteristic Dallas bravado, put it to best use.

Thank you.