I am grateful to Cindy Dietz for inviting me to speak to you today. Waco holds a special place in my heart. My daughter Alison was presented at the Cotton Palace Pageant. My son Anders was an escort before that. And it was here, at Ridgewood, that I managed my first birdie after I took up golf, playing with Bill Dietz. And, as many of you know, Ruth Collins Hall at Baylor is named for one of my all-time favorite in-laws—my wife Nancy’s grandmother. I love Waco so much that I even risked my life by giving Mark White a big abrazo at last weekend’s football game in College Station—in plain sight of the A&M regents!

Your Bears, by the way, gave it a valiant try.

This week marks the six-month anniversary of my becoming president of the Dallas Fed. It has been an interesting time, to say the least. My previous government service came as a Treasury official, then as a trade negotiator. Contrary to accepted wisdom, the most difficult negotiations are not with the Chinese, the Vietnamese, the Chileans or the Mexicans. They are with the lobbyists and special interest groups in Washington. I don’t miss the cutthroat shenanigans of the political realm. You remember that Harry Truman defined a friend in Washington as someone who stabs you … in the chest.

I’m in a kinder, gentler place now. As Dallas Fed president, I sit on the policymaking Federal Open Market Committee. It was Dallas’ turn at bat, so I am a voting member in my rookie year. The committee conducts the important work of monetary policy with great civility and sense of purpose. Just as important, it conducts its affairs with total independence and zero partisan or political intrusion.

Before becoming president, I had little appreciation for what I call the Dallas Fed’s factory side. Like the 11 other Federal Reserve banks, we clear checks for financial institutions and meet their needs for cash. You might be surprised at the size of these operations. We will process nearly 1 billion checks this year in Dallas. During a typical month, more than 140 million bills of all denominations pass through our vaults. Three mammoth machines scan the notes at a rate of 90,000 an hour. They cut out any counterfeit money. They pluck out worn bills and send them off to Money Heaven. The life span of a typical $1 bill is just 22 months. A $100 bill lasts longer—nine years.

I want to speak to you today about money and the role of the Federal Reserve, not so much the factory side, as the monetary policy side.

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 now paid to do! Central bankers spend much of their time contemplating the nature of money—how best to protect its value; how best to use monetary policy to promote growth with low inflation; how best to manage the payments system to keep our financial infrastructure humming at peak efficiency.

Money has fascinated the human race from time immemorial. We know from the writings of Herodotus, the Greek historian, that it was the ancient kings of Lydia who invented money as we know it, sometime around 700 B.C. The Lydians enumerated value not in head of cattle but in coins they called “electrum,” an amazingly farsighted nomenclature when you consider that today money zips around the planet via electronic impulses.

Since the Lydians, just about every writer of note has tried—and failed—to get the last word on money. Sophocles and Aristotle, Aristophanes and Horace and Virgil, Chaucer and Dante and Shakespeare—all wrote endlessly about money and its effect on human activities.

Ezra Pound spent 50 years writing a single poem about money—The Cantos.

Somerset Maugham wrote: “Money is like a sixth sense without which you cannot make a complete use of the other five,” something my friend B. Rapoport has taken to heart for decades and with it has done so much for Waco and America.

I once had a needlepoint pillow sewn with a quote from Moliere, the French playwright, to convince my wife, Nancy, to quit the board of the Washington opera. It read: “Of all the noises made by man, opera is the most expensive.”

Now, how does the Federal Reserve deal with money?

The short answer: very seriously.

Money flows are an economy’s lifeblood, and the Federal Reserve’s great responsibility lies in maintaining the cardiovascular system of American capitalism. The Federal Reserve’s factory operations—from payments processing to bank regulation to the New York desk’s trading activities—keep open the arteries, veins and even the capillaries of capitalism. We cannot let the equivalent of sclerosis block the arteries and disrupt the workings of the circulatory system.

Nor can we let the inflation virus infect the blood supply and poison the system. Inflation robs us of all that we might otherwise produce with a sound currency. It forces business to think about accounting rather than production. It distorts decisionmaking by investors. It penalizes the elderly and those who live on fixed incomes. It cheats the consumer, especially those in the lower income brackets. It robs savers of the underlying value of their money. As one cynic once put it, under inflation, a dollar saved is a quarter earned.

Milton Friedman looked at the evil of inflation in a slightly different way: “Inflation is the one form of taxation that can be imposed without legislation.”

Inflation was not always a threat. The United States once operated on the gold standard, which did a pretty good job of delivering price stability. Between 1820, when the United States went on the gold standard, to 1932, when it was abandoned, the average annual inflation rate was essentially zero. Since 1932, it has averaged 3.8 percent, although in recent years we have been doing better than that, a tendency we aim to continue.

The gold standard’s price stability came at a high cost. Painful recessions and fearsome depressions destabilized the economy far too often. America abandoned the gold standard at the depths of the Great Depression. In the seven decades since, the dollar has been what economists call a fiat currency. It is not backed by gold or...
any other commodity. Its value relies solely on confidence in the full faith and credit of the United States. Although inflation has been higher since 1932, we have had longer periods between recessions, and our downturns have been shallower and shallower.

Tamping down the economy’s swings has brought great benefits, but controlling inflation is no longer as automatic as it was on the gold standard. We at the Federal Reserve now sit as the bulwark against inflation—a task done reasonably well in the past two decades, not as well at other times.

We Texans all remember the inflationary episode of the late 1970s and the painful steps the Federal Reserve had to take under Paul Volcker to correct excessive accommodation of those inflationary forces. We never want to be put in that position again.

All you need to know about central bankers is that we abhor inflation.

I always carry in my pocket a quote from Benjamin Franklin as a reminder of my obligation as an inflation fighter. In 1748, when we were an agrarian society and the crown was the colonies’ currency, Franklin said, “He that kills a breeding sow destroys all her offspring to the thousandth generation. He that murders a crown”—a dollar—“destroys all that it might have produced.”

Inflation has been on a slight upward tilt the past couple of years. Readings on core inflation have been within the acceptable range of 1 to 2 percent, but they are edging closer to the upper end of the Fed’s tolerance zone, with little inclination to go in the other direction. As a result, we are in a tightening phase of monetary policy. At the last meeting of the Federal Open Market Committee, I joined eight other members in voting for the 11th straight quarter-point increase in the federal funds rate, raising it to 3.75 percent.

In contemplating monetary policy from this point forward, the brow begins to furrow. Most forecasters expect growth to slow from its previous pace—not so much because of the frightful destruction Hurricanes Katrina and Rita inflicted on the Gulf Coast but due to additional volatility in prices for natural gas, gasoline, certain chemicals and building supplies. To protect their profits, businesses may become more aggressive in pressing for price increases.

Will prices increase more broadly, or will the economy slow as profits get further squeezed? Or will both happen simultaneously?

The honest answer is: I do not know.

Another reason for anxiety lies in the federal government’s fiscal predicament. I have a great many conversations with business leaders, and my soundings indicate that the markets are becoming wary of our deficits. Financial markets, I am sure you know, are a powerful disciplinary force. You may recall James Carville, the hardball Clinton political advisor who is now a frequent television commentator. He famously said: “I used to think if there was reincarnation I wanted to come back as the president or the pope . . . but now I want to come back as the bond market. You can intimidate everybody.”

At times of large fiscal deficits, 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 those increasing 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 and become more efficient. We have outgrown and outshone all the other major economies, as the World Economic Forum’s reports have shown. These studies rank the United States as the second most competitive economy in the world, behind Finland. I’ll pocket that. Finland has an economy the size of Connecticut’s. With a GDP of $12 trillion, the United States eclipses the combined economies of Japan, Germany, Britain, China and India. Texas alone produces 21 percent more than India. California produces more than China.

We are an economic colossus, the world’s most efficient economic machine. 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 on 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 recoil from 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. They despise protectionism. 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, Congressman 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 any central banker worth his or her salt is 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, risk sending highly mobile capital scurrying to more tax-friendly destinations, destroying investment and jobs as it leaves.

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.

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 Texas confidence, put it to best use.

Thank you.

About the Author

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The views expressed by the author do not necessarily reflect official positions of the Federal Reserve System.