

Globalization and Texas

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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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By Richard W. Fisher

Being in Houston puts a spring in my step. This is a great and gutsy city, a place that is much more than America's fourth-largest metropolitan area, the energy capital of the world, the proud home to the world's largest medical center and the leader in the industry that serves our greatest quest—the exploration of space. This is the home of the Astros, a team that this season picked itself up after a dismal start and tonight takes another shot at becoming the first Texas team to play in the World Series. Baseball, like life, mixes heartache and hope. I am rooting for the Astros to bounce back from Monday night's last-inning loss and win tonight in St. Louis. They had better: I have a big bet with Bill Poole, president of the St. Louis Fed, and I hate to lose.

I am grateful to the Houston Forum for inviting me to speak today. Speeches delivered by Federal Reserve Governors and Bank presidents are subject to interpretation in a manner akin to the ancient art of prophecy, which often divined the future by slicing open an animal and studying its entrails. It is interesting to be the “slice-ee,” but this is nothing new. I am grateful to columnist Philip Coggan for reminding me of how policymakers live under watchful and ever suspicious eyes. Writing in the *Financial Times* last week, he noted that when the great French statesman Talleyrand died, his archrival, Prince Metternich of Austria, was heard to muse, “I wonder what he meant by that?”

I am a plain speaker. And plainly stated, my job—like that of each and every Federal Open Market Committee member—is simply to use my best judgment to craft monetary policy that promotes maximum sustainable noninflationary economic growth.

The FOMC convenes every six weeks or so in Washington, bringing together the 12 regional bank presidents and the Fed Governors. Five of the seven Governor slots are presently filled, including the one held by the Chairman, Alan Greenspan. In meetings marked by civility and candor, each of us presents our views on the economy and recommendations for what the committee should do. Then a vote is taken to set policy. All of the Governors and five of the Bank presidents vote. This year, I am one of them.

How do I, as a member of the FOMC, approach my duty? Let me describe the process.

When I prepare for an FOMC meeting, I consider three things, assisted by the economists at the Dallas Fed and the staff at our branches in Houston, San Antonio and El Paso, as well as by the staff of the Board of Governors.

First, I ask: What do the economic statistics tell me? By their very nature, statistics are backward looking; they record the past. Too much reliance on statistics is as dangerous as driving by

looking only in the rearview mirror, but they do provide useful input, a snapshot of what has been the prevailing situation.

Second, I look at economic forecasts, so I am at least looking ahead through the windshield. Forecasts give an imperfect picture, however, because they are based on economic models and the assumptions behind them. Only if history repeats itself do forecasts provide a good guide to what to expect. Although history rarely repeats, it does on occasion echo, so forecasts are useful.

The third pillar—where I spend the majority of my preparation time—centers on the experiences of CEOs, COOs and CFOs at the dozens of companies, large and small, that I regularly talk to. These are real-time decisionmakers who are on the front lines, doing the business of America. They are where the rubber meets the road in the economy, and they are one of the key inputs the Federal Reserve needs in formulating monetary policy. These business leaders are often the first to spot the dominant and shifting trends—whether their pricing power is nonexistent, as I was hearing in the spring and early summer, or whether pricing power is on the rise, as I’ve been hearing recently.

My recent soundings on all three fronts have caused my brow to furrow, reflecting concerns about the drag on growth by Hurricanes Katrina and Rita and the increases in energy prices. Several questions arise. How permanent are these influences? Will business confidence resume and growth snap back? Will energy and associated costs work their way into core inflation?

To these questions, I must give an honest answer. At the moment, I really don’t know. Our statistical measures and modeling techniques are less reliable now because of the flux introduced by the hurricanes and their aftermath. At times like this, we must listen carefully to the anecdotal evidence from those on the ground and heed the lessons of experience.

Looking past the uncertainty of the near future, I take comfort in the resiliency of the U.S. economy and the uniqueness of the American way. We have several comparative advantages, all of which are summed up for me in the immortal words of the great poet Langston Hughes, who wrote in “Democracy”:

I have as much right
As the other fellow has
To stand
On my two feet
And own the land.

The business operators of Houston and every other city in this country get up every morning, stand on their own two feet, and venture forth to compete and capture what is theirs.

We have millions of managers in our business community who have become experts at adapting to economic change with breathtaking alacrity. I am talking not just about CEOs but also about middle managers who operate supply chains, control inventories and fine-tune operations in our mighty economic machine. They are an important reason we have succeeded in growing our

economy while others—great nations like Japan and Germany—had been stagnant, at least until adopting recent market-oriented reforms.

These decisionmakers are the real secret to U.S. economic prowess. Because of them, we have overcome the spasms of self-doubt and doomsday forecasts of well-meaning but cynical analysts, academics, editorialists and other pontificators. Remember such best-sellers as Ezra Vogel's *Japan as Number One* and Paul Kennedy's *The Rise and Fall of the Great Powers*, just two of a frenzy of tomes that forecast our economic decline in the 1990s? A lot of money was lost betting against American management's capacity to cope with the challenges of a global economy.

We lost neither our way nor our sway.

I am confident that American moxie will power a recovery from the wrath of Katrina and Rita—and then some. I don't know precisely how long it will take, but I am confident that it will take place, and probably faster than the consensus handicap.

Of course, for the magic of free enterprise to work, fiscal authorities and central bankers must provide a healthy economic environment for the private-sector managers who hold our destiny in their hands. The authorities must do so in a challenging new global environment.

Since becoming Dallas Fed president, I have been stressing the importance of globalization—the trend toward falling international barriers to goods, services, people, money and ideas, a process aided by the interconnective properties of technology. It may well be the key development of our era; yet, we do not understand it very well. Hoping to change that, I put in place a new research program at the Dallas Fed that seeks a more systematic understanding of how globalization impacts the pricing behavior of businesses and its implications for inflation and monetary policy.

This is an ideal place to advance my theme of globalization. Houston is truly one of America's most vibrant international cities. For decades, it has been a leader in that most global of industries, oil and gas exploration. With no natural base for trade, Houston carved out a 50-mile ship channel and created a port that has grown into the nation's largest in terms of international tonnage. The city hosts 82 foreign consulates, ranking third in the country, and Houstonians speak 90 languages—not counting Texan. When I stress the importance of globalization, I am preaching to the choir here in Houston.

Globalization has intensified worldwide competition for investment capital. The consequences have included pushing governments to simplify or lower tax burdens to attract these funds. Competition also provides an incentive for legislatures and parliaments to maintain the rule of law, minimize obstacles to flexibility and maximize the ability to compete. High tax rates and excessive government interference in economic activity have been hotly debated issues in recent elections in Germany and Poland, for example.

In the United States, the executive branch, Congress and their counterparts in the states take responsibility for the fiscal side. The Fed is rigorously nonpartisan, but that does not mean we are oblivious to fiscal policy as it impacts the economy. The minutes of our last FOMC meeting

summarized the concerns in the wake of the hurricanes as follows: “The substantial step-up in government spending would add to federal deficits that were already large and underscored the worrisome loss of fiscal discipline evident in recent years.”

The forces of international competition may be heralding a period when decisionmakers responsible for fiscal policy are forced to focus on investment rather than public-sector consumption. In much of today’s newly competitive world, governments’ purpose in spending is to build an economic infrastructure that fosters private-sector production and growth, rather than transferring spending from one part of society to another. In an increasingly global economy, where resources migrate toward the best economic environment, a dollar’s worth of government spending on consumption or entitlements has a higher opportunity cost today than it did yesterday. This will likely lead to a reconfiguring of government decisionmaking that in the past has short-changed infrastructure, research, education and other more productive public investments.

But that is for politicians to ponder.

The job of the central bank centers on managing the monetary system so as to encourage sustainable, noninflationary growth. It is important to understand that the Federal Reserve’s charter differs from that of other monetary authorities. The European Central Bank, for example, is charged only with countering inflation. The Fed has a dual mandate to encourage the greatest sustainable employment with stable prices. Price stability is a necessary condition for achieving maximum sustainable economic growth. Central bankers have always—since the invention of central banking—been preoccupied with price stability and recoiled from inflation. It is a destructive force that erodes confidence, gnaws away at the value of money and undermines growth. We never want to let it out of the bag. In this key sensitivity, I am no different than the men and women who have gone before me.

I have spoken elsewhere of the dangers of inflation, *were it* to take root. Here the Fed watchers who read entrails might take note: I am fully confident that the Fed will continue to do its part by containing inflationary expectations and pressures.

On the inflation-fighting front, globalization has been a positive factor. Based on our work at the Dallas Fed, we know that globalization has provided a powerful counterforce to domestic inflationary pressures. Some of these are obvious. By lowering trade barriers and by opening to new economic participants that range in size from China to Estonia, we have benefited on the inflation front from the stiff competition of the global marketplace. At the same time, competition from abroad acts as a check on price increases by our own producers. In our Dallas Fed business surveys, companies tell us that globalization has meant they have less pricing power than they once had. It makes life harder for them, but it is good news for consumers. All you have to do is wander down the aisles of any Wal-Mart or Target or JCPenney’s or 7-Eleven to see what I am talking about.

Let me illustrate the point with a few numbers that cover the time between when I left Dallas at the end of 1997 for Washington to be a trade negotiator and my return to assume my present position.

Prices for goods and services *not* internationally traded and *not* subject to foreign competition have risen since 1997: college tuition and fees, up 63 percent; cable and satellite television, up 43 percent; dental services, up 42 percent; prescription drugs and medical supplies, up 40 percent.

But prices of goods subject to foreign competition have fallen over the same period: by 88 percent for computers and peripherals, 70 percent for video equipment, 39 percent for toys, 13 percent for women's outerwear, 16 percent for men's shirts and sweaters. Services prices have been impacted, too, by cheaper software programmers in Russia, call centers in India and other processing that can be shifted offshore.

To be sure, the growth of Russia, India, China and other new economic entrants has created upside price pressures, too. They materialize in some interesting ways. The *New York Times* had an intriguing article Monday on the price of cowboy hats. The well-dressed cowboy likes to have at least one Stetson or Serratelli. Their best hats are made of felt from the belly fur of beavers. The *Times* reports that "the best quality beaver is often ending up in the hands of foreign competitors," and quotes Dean Serratelli as saying, "Russia and China have been gobbling them up." Then it goes on to quote cattle auctioneer Bill McCoin, who laments that "it used to be you could pay \$30 for a hat ... now you pay \$300." And he adds, in a testament to fine American craftsmanship and the drive to have quality offset price increases, "I bought my best hat for my wedding. It was a real good hat: it outlasted my marriage."

In addition to the hat makers, other producers have felt some upward pressure on non-energy commodity prices driven by new sources of global demand. Steel is a case in point—as are copper and so many other commodities. Even so, I feel that the net effect of new entrants like China into our markets, and the competition for efficiency they engender among our talented corps of American managers, has been a plus in exerting downward pressure on core inflation. I refer to this phenomenon internally at the Dallas Fed as "cost-pull *disinflation*." As long as we keep our markets open and hold protectionists at bay, I expect this will continue.

The issue at hand today is whether business operators can combine these lower priced imports with other methods of cost containment and efficiency to offset the cost increases on natural gas, heating oil, gasoline at the pump and other energy-sourced products. We shall see. This past week, for example, some big retailers announced early discounting and other aggressive price-cutting measures to offset the rising costs of their customers' gasoline and heating bills. And there is mixed evidence of wage-price pressures in the economy. Without globalization, I doubt we could be containing price pressures so readily.

And yet, inflation has exhibited a slight upward tilt in the past couple of years. Once again, I refer to the minutes of the Sept. 20 FOMC meeting, which noted that "participants' concerns about inflation prospects generally had increased" since the previous meeting. The minutes went on to say that "the surge in energy prices, in particular, was boosting overall inflation, and some of that increase would probably pass through for a time into core prices. This posed the risk that there could be a more persistent influence on inflation should inflation expectations rise."

“Indeed,” the minutes suggested, “some recent survey evidence on such expectations had been troubling, and widening federal deficits were mentioned as a factor that could further stir inflationary concerns. ... Still, core inflation in recent months had been quite damped, and ... it was observed that, after the early 1980s, the pass-through of energy prices into core inflation had been quite limited, suggesting that, in current circumstances, core inflation could stay relatively low and overall inflation would probably drop back if inflation expectations remained contained.”

You will note that the operative phrase in the discussion was “inflationary expectations.” A key to containing them is the conduct of the FOMC. For my part, as a member of the FOMC, I will not waver from advocating policy that discourages expectations of higher core inflation. The object will always be to keep inflation at bay, so that the American business machine can keep on humming.

Houstonians understand business. This great city was built by enterprising people. Like John Henry Kirby, Hugh Roy Cullen, William and Oveta Culp Hobby, Ben Love, Bob McNair, Roy Hofheinz, Red Adair and Jesse Jones. You know the true value of a dollar. And you don't suffer fools. So let me conclude with my favorite quote of the great, four-time British prime minister, William Gladstone: “Not even love has made such fools of men as the contemplation of the nature of money.” To avoid proving Gladstone right, I'll exit stage right, right now.

Thank you.