A New Perspective on Policy

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I am delighted to be back in Wichita Falls. I spent some considerable time here in 1994, when I took leave of my senses and ran for the United States Senate. The good people of this city were always nice to me, especially Dottie Murphy, who is here today—thank you, Dottie. I remember the first time I met your wonderful mother, God rest her soul. She had on a white blouse, a jean skirt and bright red cowboy boots, and she looked a third her age and like the belle of the ball. She was a true Texas gem, and we all miss her.

I ran that one time for office and that was it. Veni, Vidi, Defici: I came, I saw, I lost. It was not my cup of tea; I was no good at it and was a fish—or, I guess you can say, a fisher—out of water. I was better suited for the assignment of ambassador and trade negotiator of the United States. That, in turn, proved to be excellent preparation for what I do today as president of the Federal Reserve Bank of Dallas and as a participant in the Federal Open Market Committee, the monetary policy setting body of the Federal Reserve System. Today is, in fact, the anniversary of my becoming Dallas Fed president last year. So I thought it might be of interest to share with you what I have gleaned from these past few years and what I am now up to as we speak. Before doing so, let me state at the outset that the views I express today are strictly my own and that I am not speaking for the Federal Open Market Committee or others in the Federal Reserve System.

And before getting into my prepared remarks, I want to acknowledge my traveling companion today, Wichita Falls' and Midwestern's own James Hoard. James is my right arm at the Fed. He is a superb counselor and friend and does his best to keep me out of trouble. James, raise your hand, so that if I do make any mistakes today, everyone will know who to blame.

One of my first acts as Dallas Fed president was to challenge our researchers to think deeply about how globalization is changing the ways our economy works—in particular, how we need to alter the rules and practices of monetary policy to accommodate an increasingly interconnected, interdependent global economy.

The literature on globalization is large. The literature on monetary policy is vast. But literature examining the combination of the two is surprisingly small.

At year-end last year, if you had Googled "globalization" and "monetary" and "policy," you would have turned up more than 2 million references. However, a search of scholarly articles with the same word combination turned up 30,700. If you had narrowed your quest to the exact word combination "globalization and monetary policy," you would have found a mere 39 citations. Limiting the word combination to the title of an article, you would have found only two.

Tom Friedman's popular book *The World Is Flat: A Brief History of the Twenty-First Century*—a book I'll bet many of you have read—doesn't have a single entry on "money," "monetary policy" or "central banking." And in Michael Woodford's influential book *Interest and Prices: Foundations of a Theory of Monetary Policy*—a book you probably haven't read but should if you delight in economics—the word "globalization" does not appear in the index. Nor do the words "international trade" or "international finance."

What gives? Is the process of globalization disconnected from monetary policy? Is the business of the central bank totally divorced from globalization?

I think not. I believe globalization and monetary policy are intertwined in a complex narrative that is only beginning to unfold.

There are many convoluted definitions of globalization. Mine is simple: Globalization means economic potential is no longer constrained by political and geographic boundaries. A globalized world is one where goods, services, capital, money, workers and ideas migrate to wherever they are most valued and can work together most efficiently, flexibly and securely.

Where does monetary policy come into play in this world? Well, consider the task of the central banker, seeking to conduct monetary policy to achieve maximum sustainable non-inflationary growth.

Former Federal Reserve Governor Larry Meyer gave an insider's view of the process in his excellent little book *A Term at the Fed*. It was one of the first things I read as I prepared for my new job. In it, you get a good sense of the lexicon of monetary policy deliberations. The language of Fedspeak is full of sacrosanct terms, such as "output gap" and "capacity constraints." There is the "natural rate of unemployment," which morphed into "the non-accelerating inflation rate of unemployment," or "NAIRU." Central bankers want GDP to run at no more than its theoretical limit, for growing too fast for too long might stoke the fires of inflation. They do not wish to strain the economy's capacity to produce.

One key capacity factor is the labor pool. A shibboleth known as the Phillips curve posits that unemployment falling beneath a certain level ignites demand for greater pay, with inflationary consequences for the entire economy.

Until recently, the econometric calculations of the various capacity constraints and gaps of the U.S. economy were based on assumptions of a world that exists no more. Meyer's book is a real eye-opener because it describes in great detail the learning process of the FOMC members as the U.S. economy entered a new economic environment in the second half of the 1990s. At the time, economic growth was strong and accelerating. The unemployment rate was low, approaching levels unseen since the 1960s. In these circumstances, inflation was supposed to rise—if you believed in the Phillips curve and the prevailing views of potential output growth, capacity constraints and the NAIRU. That is what the models used by the Federal Reserve staff were saying, as was Meyer himself, joined by nearly all the other Fed governors and presidents gathered around the FOMC table. Under the circumstances, they concluded that monetary policy needed to be tightened to head off the inevitable. They were frustrated by Chairman Greenspan's insistence they postpone the rate hikes.

We now recognize with 20/20 hindsight that Greenspan was the first to grasp changes in the traditional relationships among economic variables. The former chairman understood the data and the Fed staff's modeling techniques, but he was also constantly talking—and listening—to business leaders. And they were telling him they were simply doing their job of seeking any and all means of earning a return for shareholders. At the time, they were being enabled by new technologies that enhanced productivity. The Information Age had begun rewriting their operations manuals. Earnings were being leveraged by technological advances. Productivity was surging. Inflation wasn't rising. Indeed, it just kept on falling.

If the advice of Meyer and the others had prevailed, the Fed would have caused the economy to seriously underperform. According to some back-of-the-envelope calculations by economists I respect, real GDP would have been lower by several hundred billion dollars. Employment gains would have been reduced by perhaps a million jobs. The costs of not being right on the critical calibrations of monetary policy would have been huge.

We live in a globalizing era. Just consider what the fall of the Soviet Union, the implementation of Deng Xiaoping's "capitalist road" in China and India's embrace of market reforms mean to business operators. Consider labor alone. In the early '90s, the former Soviet Union released millions of hungry workers into the system. China joined the World Trade Organization at the turn of the century and injected 750 million workers into play. And now India, with over 100 million English-speaking workers among its 1 billion people, has joined the game. Just two weeks ago, a CEO told me his company posted ads for people to apply for 9,000 jobs in a new facility in India. Do you know how many applications they received?—1,400,000.

How does this affect the American manager—paid to enhance returns to shareholders by growing revenues at the lowest possible costs? Because labor accounts for, on average, about two-thirds of the cost of producing most goods and services, the managers will go where labor is plentiful and cheapest. They will have a widget made in China or Vietnam, or a software program written in Russia or Estonia, or a center for processing calls or managing a back office set up in India.

Let me tell you of one eye-opening experience. About two years ago, I was in London on business for Kissinger McLarty. I received a call from the head of Japan's equivalent of the Business Roundtable, the Keidanren, asking me to "pop over tomorrow to give a luncheon and dinner speech." They made an offer I couldn't refuse, and I said I would be glad to do it if they could arrange the flights. They booked me on Virgin Air and arranged for a car to take me to Heathrow. At the appointed time, the car didn't show up. So I called the number I had been given. The call was answered by a woman with a frightfully British accent. When I asked, "Could you kindly tell me where my car is, ma'am?" she deftly shifted to a Southwestern American accent and said, "Now don't you worry. It is five minutes away. Ah apologize for the delay. Have a nice flight."

I said, "Well, hold on a minute. You answered this call in a British accent but once I spoke, you shifted to a Texas accent. Who are you? Where are you?"

"Well," she answered, "I am a call center operator in Bangalore."

"Have you ever been to the United States?" I asked.

"Oh, no, sir. But I can tell that you are from Arkansas, Texas or New Mexico."

"And how do you learn to speak like me?"

"Well, sir, for people like you, we watch a telly show called *Walker, Texas Ranger.*"

"And what if I were from Boston?"

"Ah, for those people we watch *Cheers.*"

It may seem like a small matter that a Japanese firm employed a worker in India to track a car by GPS in London and mimic a voice from Texas. But globalization impacts the conduct of business so much more profoundly, and therefore it impacts the expansion of our productive capacity and the pricing mechanism of labor and other inputs.

The destruction of communism and the creation of vast new sources of inputs and production have upset all the calculations and equations of the very best economics minds, including those of the Federal Reserve staff. Many of the old models simply do not apply in the new real world. This is why I think so many economists have been so baffled by the length of the current business cycle as well as the non-inflationary prosperity we have enjoyed for almost two decades.

You could sense something was wrong with the econometric equations if you listened to the troops on the ground, fighting in the trenches of the marketplace. This is what I did at the U.S. Trade Representative's office in negotiating market-opening trade rounds with China, Vietnam, Mexico, Brazil and others. It is what my colleagues and I at Kissinger McLarty did while advising dozens of U.S. companies seeking entry into China and the former Soviet satellites and India and Latin America. It is what my colleagues and I on the FOMC do by making dozens upon dozens of calls to CEOs, COOs and CFOs of businesses, large and small, every month to prepare for FOMC meetings.

We are simply observing managers at work expanding the capacity of our economy, expanding the gap between what their previously limited resources would allow them to produce and what their newly expanded globalized, technologically enhanced reach now allows them to produce.

From this, I personally conclude that we need to redraw the Phillips curve and rejig the equations that inform our understanding of the maximum sustainable levels of U.S. production and growth. How can economists quantify what the U.S. can produce with existing labor and capital when we don't know the full extent of the global labor pool we can access? Or the totality of the financial and intellectual capital that can be drawn on to produce what we produce?

So what does the limited research on resource utilization and output gaps tell us? There are a few key, but preliminary findings from work done at the Bank for International Settlements—what many consider "the central bankers' bank"—and some as yet unpublished work done by several of our Dallas Fed economists. Here are a few key points:

- The relationship between measures of domestic economic slack, such as industrial capacity utilization, and domestic inflation seems to have declined across a broad range of advanced countries in recent years.

■ At the same time, proxies for global slack—such as unemployment rates and output gaps in a wide array of countries—seem to be of growing importance.

■ And for some countries, including—and to my mind especially—the United States, the proxies for global slack have become more important predictors of changes in inflation than measures of domestic slack.

At first, I was encouraged on hearing these results. But then I was reminded about how difficult it is to accurately measure slack in the U.S. economy in real time. Data revisions in these measurements are often quite large. Imagine how much more difficult it is to measure in real time the degree of slack or capacity utilization that exists across the landscape of, say, 10 other economies across the globe!

The realization of the importance of global economic conditions for making monetary policy decisions is becoming more widespread. Several of my colleagues on the FOMC have offered encouragement to the globalization research efforts under way at the Dallas Fed. In February, I had the opportunity to give a speech in London and to meet with Mervyn King, the governor of the Bank of England. Foreign trade has long been important to the prosperity of the U.K. London's financial markets play a pivotal role in global capitalism. So policymakers in the U.K. are used to thinking globally when it comes to making policy. After a robust conversation with Governor King, it became abundantly clear that we share many views on the importance of globalization for monetary policy. In recent years, globalization has manifested itself in the U.K. in the form of inflows of foreign workers that have alleviated labor market pressures and allowed the Bank of England to keep interest rates at levels lower than might otherwise be the case. Globalization has also shown up in greater external competitive pressures on U.K. firms, and thereby affected the dynamics of inflation in the U.K. Bank of England staff have an ongoing research project to understand the causes of what they refer to as the Great Stability and we refer to as the Great Moderation—the decline in inflation and output volatility that we have seen in many countries in recent years. Globalization is almost surely part of the explanation.

Recognition of the importance of global economic forces for the making of economic policy is not limited to monetary policy. Just last week, the Antitrust Division of the U.S. Justice Department decided not to impose any restrictions on the merger of Whirlpool and Maytag, two manufacturers of washing machines and clothes dryers that together control roughly 70 percent of the U.S. market. In the old days, this would be unthinkable. Today, the reason for not being too concerned with the potential for the combined companies to exert monopoly power is fairly straightforward. There are many manufacturers of laundry machines desirous of entering the U.S. market. In other words, there are abundant potential capacity and resources available outside the United States that can, and will likely, offer competition to Whirlpool/Maytag, thereby reducing their power to boost prices.

I freely admit to you that I do not have the answers when it comes to globalization and monetary policy. I do believe that I am asking the right questions, as are my counterparts in many parts of the world. We at the Dallas Fed will continue to explore this topic, and we will share our findings with the public. We will have to, now that I have made them public right here at Midwestern! In fact, we are putting the finishing touches on a new study about how globalization shapes public policies—from innovation to the regulatory environment and quite a bit in between. It is fascinating stuff, and I look forward to sending it to you through James in about a week or so.