The Economy at Midyear

Remarks at a Community Luncheon Hosted by the
Federal Reserve Bank of Dallas,
San Antonio Branch

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Corpus Christi, Texas
June 14, 2006

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The Latin root of the word "credit" is *credo*: I believe. As Jackson Lears wrote in Sunday's *New York Times Magazine*: "Faith [is] a necessary component of most transactions in an expanding economy." I do not know whether faith can move mountains—that is, of course, a matter of faith—but I know well the importance of faith in the great economic machinery that meshes the growing of wheat in West Texas, the making of semiconductors in North Texas, the distilling of petrochemicals on the Gulf Coast and the movement of the ships at sea that call on the nation's sixth busiest port here in Corpus Christi.

Faith is certainly the basis of your confidence in the Federal Reserve. I have spoken in previous speeches of our "faith-based currency," a term I use only slightly tongue in cheek. The dollar—like the euro, the yen, the British pound and other currencies—is what economists call a fiat currency. It is backed only by the federal government's power to raise the revenues needed to meet its obligations and by the rectitude of the U.S. central bank. If the market were to lose faith in either assumption, the dollar would be debased.

It is not my place to comment on Congress' business. With the acquiescence of its constituents, including the people in this room, the fiscal authorities have leveraged the U.S. government's balance sheet by incurring structural liabilities exceeding projected revenues to an unprecedented degree. Economists and public policy analysts have myriad solutions for restoring balance to what they see as a highly leveraged—some would say overleveraged—American ledger. Congress, as keeper of the government's purse and the sole body with the power to tax and spend the people's money, has the duty and the means to impose solutions to these imbalances.

The Federal Reserve has a different duty, performed by different means. We are charged with maintaining the monetary conditions for sustainable, non-inflationary economic growth. This task takes on heightened meaning in an era of highly leveraged government finances, for we must work overtime to sustain the faith.

I am hardly an impartial observer, but I would submit that the Fed has done its job reasonably well. The numbers provide proof: Our $13 trillion economy has been barreling along at remarkable rates of growth for a sustained period without giving rise to inflation.

We must continue to do our job.

We know how close we came to creating an economic catastrophe when the Fed took its eye off the ball in the 1970s. And we remember the enmity the Federal Open Market Committee incurred when, under the chairmanship of Paul Volcker, it so dramatically took away the punchbowl of grain alcohol that was fueling reckless economic behavior. We never again want to be placed in the position of either promiscuous accomplice to fiscal impropriety or dour party pooper.

Today, we labor under far more favorable conditions. Economic growth has been strong and prolonged. Employment is at an all-time high. And yet we have resisted monetizing Congress' spendthrift ways. Money supply growth has thus far been tapered down without jeopardizing economic growth and has restrained inflationary impulses.

But no Fed official can ever afford to become complacent. The surest way to jeopardize the goodwill earned through the Volcker and Greenspan years would be for the FOMC to brook any behavior that might fan the embers of inflation. We can ill afford to somehow encourage expectations that inflation might gain momentum. For in today's monetary realm, with markets so fluid and swift, expectations can quickly become reality.

In the marketplace, the working assumption is that the FOMC has a comfort zone for inflation, one that is quantifiable. According to this assumption, it is *precisely* quantifiable by a metric known as the Personal Consumption Expenditures deflator, stripped of energy and food prices, or the "PCE, ex-energy and food."

At the Dallas Fed, we rely on a different inflation metric, what we call the Trimmed-Mean PCE Deflator. Each month, it sets aside the prices that rose sharply and those that fell a lot, so that temporary inflationary and deflationary developments do not distort our sense of underlying trends. The Trimmed-Mean PCE Deflator captures mainstream inflationary impulses. It ignores the extremes and recognizes that people have to eat, drive and air-condition their homes.

Of late, the Trimmed-Mean PCE Deflator has been running at a rate of 2.4 percent, about 30 basis points higher than the PCE ex-energy and food. A compounding of 2.4 percent over a decade cuts the purchasing power of a dollar to 79 cents. Of course, it is reckless to extrapolate historical numbers. But this 2.4 percent rate is disarmingly close to one of the market's key indicators of inflationary expectations—the spread between rates paid on Treasury Inflation-Protected Securities, or TIPS, and ordinary Treasury bonds of 10-year maturity. Another indicator of inflationary expectations is a consumer survey conducted by the University of Michigan. In May, those polled said they expected inflation over the next five to 10 years to run at 3.2 percent a year. One always has to question whether a survey of 500 people, no matter how scientific, actually reflects overall inflationary expectations. Yet again, one turns to the math: Over a decade, 3.2 percent yearly would reduce the value of a dollar to 73 cents. To me, this is more than discomforting. It is unacceptable.

To perform the duty you expect of me, I need to be relentlessly bird-dogging inflation to prevent a debasement of your dollars. I have done this by supporting each increase of the federal funds rate agreed to by the FOMC since I joined the committee over a year ago.

This business of getting it right on inflation is by no means an easy task. Econometricians do their utmost to provide us with accurate metrics, such as the Trimmed-Mean PCE Deflator and the PCE ex-energy, ex-food. But we have yet to quantify the unquantifiable: the psychology of the marketplace.

I just attended my 35th college reunion. When I went off to school, my old-fashioned Norwegian mother, worried that Harvard professors in that heyday of radicalism might lead me astray, slipped a quotation into my pocket that read: "Skepticism is the chastity of the intellect: it should not be surrendered to the first comer." That sums up the Norwegian psyche as well as anything (even if it was borrowed from the decidedly un-Norwegian George Santayana!). Despite the fact that my genetic makeup was leavened by my Australian father's more ebullient and trusting gene pool, I have carried that original clipping with me all these years, and today, 37 years later, it is taped to my desk at the Federal Reserve Bank of Dallas.

"Skepticism is the chastity of the intellect" may seem a bit quaint in the age of Paris Hilton and Anna Nicole Smith, but I think it is a useful maxim for those assigned the dull and decidedly unsexy task of conducting monetary policy. We must always suspect the precision of numbers, even as we allow ourselves to be guided by them. And we must be ever watchful for influences that might throw off the accuracy of our econometric compasses.

So, against that background, how do I see the economy through the circumspect eyes of the Dallas Fed?

As far back as February, I suggested in a speech in London that first-quarter economic growth would exceed the 4 percent consensus guesstimate then circulating among economists. The latest revision of the GDP number came in at 5.3 percent.

Since March, our Dallas team has been reporting a rotation of the impulses for growth, with business investment in plant and equipment accelerating significantly due to the confidence of corporations in their financial wherewithal and the need for capital expansion to meet projected needs, including continual cost efficiencies. Our economists have viewed this as a partial but not insignificant offset to weakness in the housing market. Despite the rising price of gasoline, our business contacts indicate that consumers continue to buy, but at a lesser clip.

The bottom line on growth is that we see it beginning to slow from its torrid pace of the first quarter. Let me remind you that we grew at a 5.3 percent annualized rate in those first three months of the year. In our $13 trillion economy, a 5.3 percent growth rate, sustained for a year, would mean incremental growth of $690 billion, an amount equal to the entire output of India or the combined output of Indonesia, Ireland and … my ancestral Norway. If the economy achieves the current Wall Street consensus of 3.5 percent growth for 2006, that would mean increasing GDP by $394 billion, a healthy pace for a gargantuan economy in its fifth year of expansion.

The numbers I cite are adjusted for inflation. That is, they are "real," in the sense they are uncontaminated by inflation. The surest way to undermine the real growth rate we foresee from our perch in Dallas would be for inflationary expectations to take hold and begin distorting the spending and investment behavior of consumers and businesses.

Against the background of sustained high prices for oil and gasoline and the inevitable propensity of sellers of goods and services to try to pass on cost increases, the brow begins to furrow in contemplating the inflation picture. On the one hand, I know that the Trimmed-Mean PCE Deflator is running at a rate that is just too corrosive to be accepted by a virtuous central banker. But I also know, having been party to it, of the incremental tightenings to which we have been subjecting the base interest rate. And I am fully aware that there is a lag between the time we tighten the valve and the time the impact of that tightening is felt.

Mind you, I am not sure we can measure this lag effect with great precision. This is partly due to our imperfect understanding of globalization's effect on the gearing of our economy—an imperfection we at the Dallas Fed have dedicated ourselves to repairing, if not eliminating. It may also have to do with how markets have discounted the kind of titration* that occurs with the removal of previous monetary stimulus through 16 quarter-percentage-point increases in the federal funds rate, as opposed to less frequent or more dramatic moves.

This is all by way of saying that conducting monetary policy is as much an art as it is a science. We listen and watch and sniff the sounds and sights and smells of the economy as much as we measure with our advanced, constantly improving but nonetheless imperfect, econometric tool kit.

I am but one voice behind the closed doors of the room where the FOMC deliberates. When called upon by the Chairman for my reading of the economy and my recommendations, I am constantly guided by my mother's advice, especially when it comes to contemplating inflation: I believe it safest to err on the side of skepticism. I cannot speak for my 18 brethren in that room, but I have noticed that each of them harbors a tendency towards Norwegian-like angst. And while this tendency of central bankers may at times be nervous-making for some of you, I believe you would lose faith in us if we conducted our business in any other way.

*I have been eager to use this word ever since high school chemistry. Thank you for giving me the opportunity to finally do so.