

# **An Update on the Status of the Economy and Its Implications for Monetary Policy**

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*Remarks for the Annual Joint Luncheon of Commercial Real Estate Women  
Dallas and North Texas Certified Commercial Investment Members*



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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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I was really enjoying that introduction until you had to be thorough and remind this great group of folks of my midlife crisis: my run for the United States Senate in 1994. All is well that ends well. We have a great senator in Kay Bailey Hutchison, and I am much happier at the Federal Reserve, which, thankfully, is a million miles from the world of partisan politics. Amen.

By raising politics, though, you've reminded me of the Alfalfa Club and given me a bridge to what I want to talk about today.

The Alfalfa Club is one of the great Washington institutions. It holds a dinner every year that is devoted solely to poking fun at the political pretensions of the day. Tongue firmly in cheek, the club nominates a candidate to run for the presidency on the Alfalfa Party ticket. Of course, none of them ever win. Nominees are thenceforth known for evermore as members of the Stassen Society, named for Harold Stassen, who ran for president nine times and lost every time, then ran a tenth time on the Alfalfa ticket and lost again. The motto of the group, which I adopted after only one outing to describe my own misplaced run for the Senate, is "Veni, Vidi, Defici," which is loosely taken from the Latin for "I came, I saw, I lost."

Several of our fellow Texans have had the dubious honor of receiving the Alfalfa nomination, among them John Connally, Bob Strauss and Lloyd Bentsen, and also, well before they were elected president in the real deal, both "Bush 41" and our current president.

Among the alumni of the Stassen Society dearest to my heart is William McChesney Martin. Bill Martin holds the record for serving the longest as chairman of the Federal Reserve Board—even longer than Alan Greenspan. In 1966, while serving as Fed chairman under his fourth president, Martin was nominated to run for the presidency on the Alfalfa Party ticket. In his acceptance speech, he announced in jest that, given his proclivities as a central banker, he was taking his cues from the German philosopher Goethe, "who said that people could endure anything except continual prosperity." Therefore, Bill Martin announced, if he were to adopt a political platform as a presidential candidate, he planned to "make life endurable again, by stamping out prosperity." "I shall conduct the administration of the country," he said, "exactly as I have so successfully conducted the affairs of the Federal Reserve. To that end, I shall assemble the best brains that can be found...ask their advice on all matters...and completely confound them by following all their conflicting counsel.... I say to you that America is at the crossroads. And I shall do everything I can do to keep it there."<sup>1</sup>

Pundits and commentators have been bombarding you with interpretations of the last meeting of the Federal Open Market Committee (FOMC), where committee members collectively decided to not raise the federal funds rate after having done so 17 consecutive times in quarter-point increments. These same commentators are also spending a great deal of time and space divining the intentions of our committee under the new chairmanship of Ben Bernanke. With all that analysis floating around, I thought I would share with you today my own views on the present

predicament of the economy and monetary policy, as one of the 18 individuals who sit at that table offering “conflicting counsel” to the chairman of the Federal Reserve.

In suffering through all this, please remember that I speak only for myself as one participant on the FOMC. I speak only for the view from the Federal Reserve Bank of Dallas, not for the committee or for any of the other Bank presidents and governors on the committee. Each of us always speaks as an individual, and I adhere to that convention today.

Let us start with the real estate markets, the subject nearest and dearest to your hearts.

Commercial real estate markets have generally returned to more normal conditions since the boom-bust at the start of this century. After falling in the early 2000s, for example, apartment rents have risen moderately, first in high-home-price coastal areas of the country and later in inland areas such as Dallas. Retail rents have more than recovered from the declines of the early part of the decade, particularly on the East and West coasts. By the end of 2005 they were rising at a 5 to 6 percent pace in cities like Dallas and Houston. And national office rents have been rising moderately in nominal terms, as office vacancy rates have been absorbed by an expanding economy. All told, commercial market rents have recently been rising in an expanding national economy and have shifted from a disinflationary to a slightly re-inflationary factor affecting the U.S. economy.

Although rents have risen, prices for commercial properties have risen by more, perhaps reflecting the ample amount of liquidity in the capital markets looking for a place to be invested. In plain English, a lot of moola is out there chasing a limited number of sustainable projects. The result is that capitalization rates have been pushed down, raising concern among some industry analysts, especially in a condominium market that seems to reflect a disconnect between demand and supply at the margin. We have seen the effect locally with the cancellation of some high-profile building or conversion plans, and I expect there will be more.

The key area of concern in the real estate markets is the housing market. You know the facts here, so I’ll make this brief by repeating what a friend who has been a major homebuilder since 1973 recently told me: “This is the roughest, most sudden correction we have ever seen in the housing market.”

It may comfort you to know that of all the markets in America, Texas’ is among the most resilient. In fact, so far this year, single-family permits are up 11 percent from their year-ago pace—the third fastest growth rate among the 50 states and a sharp contrast to the 7 percent year-to-date decline for the U.S. as a whole. Much of our state’s strength reflects the pro-growth climate and low land prices that Texas has to offer.

But in making monetary policy for the nation, this provides scant comfort for the Federal Reserve. Nationwide, single-family permits are down 26 percent from the peak last September. We are well aware that consumption drives 70 percent of the nation’s economic growth and that a significant slug of the purchasing power of consumers has in the last few years been greatly enhanced by refinancing their mortgages in a rising-price market. During an expansion homebuilders propel the economy forward by creating jobs and buying lumber and other inputs. So we are watching the effect of the inventory correction in housing with due regard for its gravity. Builders are responding as one would expect: They are cutting staff, renegotiating prices

and getting concessions from subcontractors, and either walking away from or renegotiating planned land purchases and other contracts. This is disinflationary activity that impacts economic growth.

There is one factor that distinguishes this housing market correction from previous ones, in addition to its suddenness and depth. The industry has consolidated since the last great correction in 1991. Fewer big builders now account for more of the market. Compared with smaller builders, they have larger and more diverse customer bases, stronger balance sheets and better inventory controls. As a consequence, they build fewer spec homes, they are quicker to adjust the pace of new construction, and they have enough financial strength to cut prices in reaction to inventory upswings. As a result, the inventory cycle may not be as severe as it was in the 1970s and early 1980s. The big builders also have strong balance sheets and ready accessibility to capital from a sound banking system and frisky private equity groups. As a result, the industry will be better positioned to meet the housing needs of Americans when the homebuying climate eventually improves.

But it is clear from my perch on the economic tree that the housing downturn and the cumulative effect of energy and electricity price increases and higher interest rates, among other factors, are definitely having an impact on the consumer.

Take restaurants, for example, a sector Dallasites know better than most because we have more restaurants per capita than any other city in America. Nationwide, the industry has seen overall “guest counts” decline and has experienced a downward shift in price points, while the costs of utilities and other inputs have soared. This is noteworthy for an industry that employs some 12.5 million workers and feeds 130 million people nationwide every day, and is illustrative of a shift in the tenor of the economy.

The net effect of the correction in housing and the rise in the costs of transportation and of heating and air-conditioning our homes has been a slowdown in the U.S. economy. After all, it grew at 5.8 percent in the first quarter of this year, a remarkable growth rate for an economy our size. Let me give you some math here. Last year, the gross domestic product of the U.S. economy was about \$13 trillion. Had we continued to grow at that annualized rate for the second quarter, we would have produced an additional \$377 billion of goods and services in just six months, so large and so strong and so dynamic is the U.S. economy.

For the past few years, I have referred to the U.S. as a supercharged monster roadster that has trouble keeping its speed of growth within the limits posted by economic doctrine. Recently, the economy has downshifted, and the speedometer on our dashboard has shown a deceleration as it turned the corner from the first quarter to the second. I expect second-quarter GDP growth to be revised upward to closer to 3 percent. And my best guess one month and two weeks into the third quarter is that the speed at which we are now proceeding is roughly of that magnitude. From my vantage point, despite what you hear from some of the Eeyores in the analytical community, a recession is not visible on the horizon.

Let’s not forget, the last economic expansion lasted 10 years. The expansion before that lasted nearly as long. Recessions are becoming less frequent and less severe—in no small part owing to increased global interconnectedness.

While the speedometer indicates that the economy is growing—albeit at a slower, more sustainable pace—the problem is that the inflation pressure gauge needle is moving the other way. There is a definite increase in inflationary momentum, though like many in this room, I was delighted to see in this morning's release a reversal of the recent surge in apparel prices as reported in the headline CPI for July.

All of the relevant measurements of inflation have shown a pickup in inflation over the first half of the year. This pickup shows up in the measure of price movements in consumer expenditures excluding food and energy, the so-called core PCE. Inflation is also seen in the median CPI calculated by the Cleveland Federal Reserve Bank. And we see it in the Trimmed-Mean PCE calculated by our team at the Dallas Fed.

The differences in these key inflation measures may seem obscure to you, so let me slice this pie another way: When you dissect the components of the PCE, whether trimmed or fully garbed, you find prices increasing in 82 percent of the components measured in June, up from 73 percent in April. That means that at the end of the second quarter, only 18 percent of prices were steady or falling, as opposed to 27 percent two months earlier.

We also know that economic developments occurring outside the United States are not as readily offsetting domestic price pressures here as they were before. The Dallas Fed has taken it upon itself to better understand how globalization impacts the conduct of U.S. monetary policy. We have only just begun our work on this front, but this much we know: Capacity utilization abroad is rising. This is true in all the member states of the European Union, which are growing their economies at rates not seen in some six years. Recent revisions in the U.K.'s national accounts indicate the Brits are operating closer to capacity. For the first time in over a decade, industry surveys in Japan, the world's second-largest economy, are reporting capacity constraints.<sup>2</sup> And we all know that China reported second-quarter growth of 11.3 percent, the fastest yet in an already remarkable decade, continuing to press the envelope of what they can produce without bumping into constraints.

All of which means that as our businesswomen and men search the globe for inputs into the products they produce, the relationship between supply and demand for those inputs is becoming tighter.

You see a lot of discussion in news columns about the boom in commodity prices. Let me give you another example of how global economic growth is affecting resource utilization. According to one shipping industry leader, a portion of the international fleet of large ships that carries bulk goods across the major oceans—the so-called Panamax-size ships—is being absorbed to service coastal intra-Chinese trade. It may be that only 1 or 2 percent of this fleet has been so reassigned, but it is noteworthy that at a time of year when the daily rates on these ships usually soften, rates have actually risen over the past month and are now roughly two times what they were a year ago. As a result, it costs more for importers to ship goods to the United States for consumption here. This illustrates how global economic growth impacts the prices paid here at home.

To be sure, the U.S. economy is the world's biggest. We produce roughly a quarter of the world's output. So when our economy slows, it takes some steam out of the global engine. Yet in recent years, other economies have been retooled and restructured so as to pull themselves out of the slump they had experienced over the past decade or more—in the case of China, since Mao

took power in the 1940s. The changes these countries have engineered have started to pay big dividends in terms of growth. As a result, the U.S. economy is an increasingly smaller part of a larger, more intensely interconnected global economy. Increasing connectedness forces changes in the gearing of our economy.

Let me dwell on this for a minute in the context of our recent FOMC meeting. First, let me assure you that there are no hawks and there are no doves on the committee. I see only owls: 19 men and women who are doing their level best to devise a wise and considered policy aimed at fulfilling the Fed's dual mandate of providing the monetary conditions that foster sustainable, non-inflationary growth.

The committee decided in our last meeting that it was timely to pause, in significant part because of the lags in time it takes for the tightening measures the committee had taken over the previous 17 meetings to affect the economy's inflationary impulses.

This matter of lagged effects of previous policy initiatives is complex but crucial to your understanding of what we noodle through. Even if the U.S. were an isolated economy, there would be long lags between the time monetary policy is tightened and the slowing of the economy and inflation. And, mind you, the economy traditionally slows before inflation comes down.

From my perspective, the dynamics of this important issue of lags is impacted by globalization. Just a few years ago, the global economy was in a slump and the U.S. economy was growing slowly as it emerged from the dot-com bust. Under those conditions, with an abundance of productive resources throughout the world, output here and elsewhere could expand with little or no inflationary pressure. The easy monetary policy conducted by the Federal Reserve between January 2001 and June 2004, and by other central banks worldwide, helped get that expansion going.

A global boom has been under way for the past four years, aided in no small degree by the easy monetary policy that began in 2001. There was a lag before it kicked in, but when it did, it kicked in big-time all over the world. Global GDP has been growing at roughly a 5 percent annual rate, above the 4 percent average recent yearly rate in the U.S. This means that the rest of the world has grown faster than the United States. Excess global capacity has been increasingly absorbed, even as capitalists rush to retool and expand capacity. Inflationary pressures have risen, as evidenced by leaps in commodity prices and the example of shipping prices that I gave you a few minutes ago.

Of late, central banks around the world, including the Fed, have been reining in the accommodation they provided as a spur to global growth. With global growth running stronger than U.S. growth, I would submit that more monetary policy tightening than usual was necessary to slow U.S. growth and inflation because we have been dealing with the lagged effects of the easy monetary policy that spurred the current global growth surge. This is why I supported every one of the increases in the fed funds rate that has been voted on since I joined the Fed over a year ago.

I would also suggest that further globalization will alter the dynamics that govern the lags in our policy initiatives, although I am not yet sure just how they will change. They may become longer, increasing the time it takes for the consequences of Fed tightening measures to take hold.

Simultaneously, I am conscious of the fact that there are other ways globalization changes how markets react to and, in turn, impact monetary policy. So as not to try your patience, let me whip quickly through some of these for the sake of giving you some insight into what vexes central bankers.

Normally, short- and long-term interest rates move in the same direction. When short-term rates rise, so do longer-term rates, and vice versa. This is what analysts refer to when they speak of a positively shaped, or upward sloping, yield curve in a healthy economy. They fret when they see a flat or negatively sloped yield curve because they fear this presages an economic slowdown as investors reach out to lock in the yields on longer maturities. However, recently the globalization of capital markets, combined with a glut of savings outside the U.S., has kept U.S. long-term rates low and steady, despite our healthy economic growth. Short-term rates have risen, but long-term rates have not. The low level of long-term rates makes financial conditions easier than what would be inferred from the movement toward higher short-term rates. This in and of itself may well have lengthened the lags of the impact from tightening monetary policy.

The point is, the changes we have witnessed in the global economy over the past few years and the phenomenon of globalization matter in that they affect several channels through which both the timing and degree of the impact of monetary policy have been altered.

Now, let me bring this closer to home. Price inflation usually does not become entrenched unless accompanied by wage inflation. Until recently, the productivity of U.S. workers was advancing at the same pace as wages and benefits costs. In the last few months, however, the anecdotal evidence picked up through the Fed's Beige Book—the survey conducted eight times a year by all 12 Federal Reserve Banks of businesses in their districts—and the anecdotal evidence the Bank presidents and their staffs glean from their conversations with CEOs and other business operators all indicate an emerging and widening shortage of skilled and semiskilled workers, along with attendant upward wage pressures. This has finally begun to show up in the wage, productivity and unit labor cost statistics.

In addition to studying the numbers and consulting the remarkably comprehensive econometric models of the Federal Reserve staff and other analysts, each of the participants on the FOMC is in regular contact with the people who are in the field hands-on, operating the nation's businesses.

For example, I have a habit of regularly consulting the CEOs of 35 or so major U.S. and global companies. This was something taught to me 30 years ago by my mentor, Robert Roosa. He used to say that no chef achieves success only by following the formulae of recipe books; they also have to use their taste buds. The CEOs and other operators of the real economy that we consult are the taste buds in our effort to assist in serving up the right monetary policy. To be sure, one has to be careful with anecdotal evidence, but one thing is very noticeable of late, at least from my consultations. A year ago, the CEOs' constant refrain was: Competitive forces will not allow me to raise prices. In the past few months, however, more of them are reporting the ability to raise prices, with decreasing customer resistance.

This phenomenon of real or perceived growing pricing power introduces yet another set of lags into the monetary policy system. Once the perception of having pricing power becomes entrenched, it is difficult to alter. This is a psychological, as well as an economic phenomenon. Behaviors become habits, and habits are hard to change. This is why it is critical for monetary policy to not encourage these emerging pricing behaviors. Keep in mind, it is not just sellers whose pricing behavior is changing; it is customers' as well.

This is all by way of saying that we appear indeed to be at something of a crossroads in the economy and in the conduct of monetary policy. The U.S. economy is slowing from its unsustainable, blistering pace of earlier this year. The rest of the global economy is picking up steam, despite our slowdown. We expect that the lagged effects of our actions and those of other central banks to tighten policy will begin to tamp down the inflationary impulses we have witnessed of late. But, frankly, nobody knows with precision how the dynamics of the global economy affect these lags or the practicability of our policies. At least I don't.

So, here is the bottom line: In determining future policy, my colleagues and I will watch and listen and "taste" the indicators carefully as they come in. And, as we said at the conclusion of our last FOMC meeting, we will act accordingly. If anybody tells you with absolute conviction that the Fed is done raising interest rates or with equal conviction that they have only paused and will raise rates more starting in September or October, remind yourself that at best—and I'm being generous here—they are only guessing.

I want to conclude by reminding you that the enemy of sustainable growth, and the enemy of every person in this room, the enemy of all the people—the poor, those who are retired or living on fixed incomes, the savers and the rich investors—is inflation. Inflation is the Lex Luthor of the Superman economy that is the United States. It is a sinister force that has the capacity to charm and romance the heck out of you but in the end wreaks only havoc.

The Federal Reserve will not tolerate inflation. But that doesn't mean we need to take a sledgehammer to the economy. Going back to Bill Martin's spoof speech at the Alfalfa Club, I assure you that we have no desire to take a cue from Goethe and conduct a policy that eliminates prosperity. We endeavor to underwrite economic prosperity. And if we see, after this pause, that inflation is beginning to threaten economic prosperity, we will take deliberate and, hopefully, owlsh measures to counter it, so that the U.S. economy will continue to prosper.

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<sup>1</sup> William McChesney Martin, "Alfalfa Club Dinner Script," delivered at the Alfalfa Club Dinner, Washington D.C., January 22, 1966. Box 163, William McChesney Martin Collection, Lyndon Baines Johnson Presidential Library, Austin, Texas.

<sup>2</sup> Tankan Survey of Business Sentiment, conducted by the Bank of Japan, released July 2006.