The Federal Reserve and Texas

Remarks at a Community Luncheon Hosted by the Federal Reserve Bank of Dallas

Richard W. Fisher
President and CEO
Federal Reserve Bank of Dallas

San Antonio, Texas
August 29, 2006

The Federal Reserve and Texas

Richard W. Fisher

My name is Richard Fisher, and as the president of the Federal Reserve Bank of Dallas, I want to thank you for joining me and my colleagues today for this informal community luncheon.

I spent a great deal of time here in 1994 during what I have come to call my midlife crisis, when I lost control of my better judgment and ran for the U.S. Senate. Two positive things came out of my unsuccessful efforts on the campaign trail: first, Texans elected themselves a talented senator in Kay Bailey Hutchison; and second, well, about all I accomplished was the unique distinction of being the only person to eat at every Dairy Queen in the great state of Texas, including at the 21 DQs right here in Bexar County. I like to say that I labored in the vineyards of politics but all it yielded for me was prune juice. The truth is it yielded a lot of Blizzards, Dilly Bars and Dip Cones, and about 10 extra pounds.

I am especially delighted to see Tom Frost in the audience today. Of course, you all know the special relationship Frost Bank has with San Antonio. Tom also has a very special relationship with the Dallas Fed and our branch office here in San Antonio. In keeping with his family tradition of being a friend to the Federal Reserve Bank of Dallas, Tom has been a trusted advisor to our bank since 1967, having served a total of 12 years on the boards of directors of our Dallas and San Antonio offices and another three and a half years on our Federal Advisory Council. And thanks to Tom, Dick Evans—the talented CEO of Cullen Frost—serves on our board today, always providing a keen and insightful view from San Antonio.

So rich is the Frost family's involvement with the Dallas Fed that earlier generations served on our original organizing committee in 1914, after the Federal Reserve Act was signed by President Woodrow Wilson in 1913. Twelve Reserve Districts were to be set up around the country, with the Eleventh District to be headquartered in Dallas. When the San Antonio Branch opened in 1927, it was housed in leased office space in the Frost National Bank Building. The local newspaper thought that was pretty good stuff and wrote that having a Fed outpost here "had changed San Antonio from a financial water-hole to a financial roundup."

Tom, thank you for being here today, and thank you for all you and your family have done to help the Federal Reserve, the Eleventh District, this city, our great state and our country.

Before lunch, I had the pleasure of meeting with the presidents of many of the banks located in the San Antonio and Austin metropolitan areas. They were kind enough to share their observations, impressions and concerns about what is happening in the local economy. I learned a great deal from their thoughtful comments. Both cities play important roles in promoting Texas' economic health, and I have gained a better understanding of why they continue to grow faster than other parts of the state.

The local banking sector is doing very well. A total of 180 financial institutions operate in the greater Austin and San Antonio areas, with more than 850 branches holding $58 billon in assets. Just as important, 95 percent of these banks were profitable during the first half of this year.

These banks report strong growth in loans for commercial real estate and construction and land development over the past four years.

Let me say a word about Austin, as it appears to me that over time, from a commercial standpoint, the capital and San Antonio are increasingly blending together and playing off one another in just the right way. Austin is the state's high-tech capital and a world leader in innovation. Austin's second-quarter venture capital investment was more than double what it was a year ago, and the city ranks third in the country behind Silicon Valley and the Boston area in this vital measure of technological prowess. In a typical year, Austin residents and companies top all other tech centers except Silicon Valley in patents granted. Firms from around the country and around the world are relocating to Austin, attracted by the city's well-educated and highly skilled workforce, advanced technological infrastructure and cost advantages. A recent survey by *Expansion* magazine ranked Austin as the most attractive city in the country for future business relocations.

San Antonio is booming. Amen. Employment has been growing at a healthy pace—at 4 percent last year—because of expansion in health care, financial services and manufacturing. When Toyota opens its new plant this fall, factory jobs will get another shot in the arm. The leisure and hospitality sector continues to provide a stable base for the local economy, and San Antonio is on track for one of its best convention years since 2001. Military spending has long been an important driver for San Antonio, and the National Security Agency's new facility will have significant spillovers. Besides the obvious benefits to housing and retail, it will also boost education programs at the area's universities.

But maybe we shouldn't talk too much about the NSA. They might be listening.

I don't know whether the NSA is listening, but as you can see, the press is here, so you can bet that some one is listening. When I give a speech, I am aware that many come to extract clues about which way interest rates are going to move. I don't expect today will be any different, so let me issue the usual disclaimer that I speak only for myself, not for the Federal Open Market Committee, nor for any of the other committee members. And let me assure you that I will consider this a successful speech if I manage to convey no clues whatsoever on the interest rate front.

A couple of days ago, I told another audience that our economy is at a crossroads, an opinion that has not changed. Using the word "crossroads" brought to mind a story about William McChesney Martin, who served as Federal Reserve Board chairman longer than anyone, even Alan Greenspan. The Alfalfa Club is one of the great institutions in Washington, D.C. Once a year, it holds a dinner 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 is "Veni, Vidi, Defici," a phrase loosely taken from the Latin for "I came, I saw, I lost."

Bill Martin was nominated to run on the Alfalfa Party ticket in 1966, while serving as Fed chairman under his fourth president. 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, Martin continued, he would adopt a platform proclaiming that as a president 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." Martin told his audience that "America is at the crossroads. And I shall do everything I can do to keep it there."

Martin gave his Alfalfa Club speech 52 years after Congress passed the Federal Reserve Act and President Woodrow Wilson signed it into law so as to encourage, not stamp out, economic prosperity. One of the more successful and brilliant aspects of this legislation was the creation of the 12 regional banks. The Fed could have been set up solely in Washington, like so many other institutions of the central government. Having representatives from all parts of the country, however, brings a deeper, more diverse perspective (and occasional "conflicting counsel"!) to the policy debate at the meetings of the Open Market Committee when we collectively determine monetary policy, giving a clearer view of what is really happening in the U.S. economy. The regional banks maintain branch offices in cities within their district to stay in touch with local economic conditions and business leaders. Indeed, our view of things from Dallas is greatly enhanced by the efforts of our distinguished branch directors and outstanding staff in San Antonio, who keep a watchful eye on economic trends in the city, Austin and South Texas.

Of course, the sexy bits of the Federal Reserve—or at least the stuff that the press and the markets seem to find seductive and just can't seem to get enough of—deal with monetary policy. But to really understand us, you need to know a little about the businesses we operate as a part of the central bank of the United States. Let me tell you about the business of the Eleventh Federal Reserve District, all derived from our charter to maintain and protect the monetary system our citizens rely on.

I have the privilege of representing the more than 1,300 people who work at the Dallas Fed and our branches in San Antonio, Houston and El Paso. One of our duties is to process checks. We process 1 billion paper checks a year, worth about $900 billion. Every day, we handle 4.3 million paper checks. Processing these checks requires us to sort them into 1,748 different stacks, each belonging to a different bank in our district or other districts. Due to advances in technology, many banks now send us checks electronically in a digital format. We receive and process between 800,000 and 1.1 million electronic images each day. Not all banks have converted to electronic processing, so we have to re-create physical checks from the electronic images. On average, we print out 506,000 electronic checks each day and add them to our bank stacks.

In addition to processing checks, we provide the blood supply—the currency—that flows through the veins and capillaries of a sprawling district that, if it were a country, would be the 12th largest economy in the world, producing some 20 percent more output than India. We supply the liquidity banking customers need in good times and bad, and we work double time—overtime in times of trauma, such as Y2K, September 11, 2001, and last year's devastating hurricanes—to keep the heart of the Texas economy pumping.

Even in these days of credit and debit cards and electronic payments, you can't overstate the importance of cash. When I was a student at Oxford, the great insurance magnate, Clement Stone, came to speak at the Oxford Union. A student asked him to kindly share with those of us in the audience what he considered the key to success. He looked out at the audience, curled up his Ronald Coleman mustache and said: "In one word: cash." Well, the Dallas Fed stores and circulates a lot of it. Our main vault in Dallas is the size of a five-story building.

If you ever need to do your laundry or park at a meter, call me. Our vaults contain more than 150 million quarters.

And lots of dollar bills. We distribute and receive 5.4 billion circulating banknotes each year, worth nearly $92 billion. That's almost $400 million in cash passing through our offices every day. This is a thing of beauty to watch. The mammoth machines scan the cash at a rate of 90,000 bills per hour. They cull out about 825 counterfeit bills each month. They pluck out almost 40 million worn bills each month—valued at $517 million—and send them off to Money Heaven. The life span of a typical $1 bill, incidentally, is just 18 months. A $20 bill lasts four years, and a $100 bill lasts nine.

Among the regional banks' other responsibilities is supervising the banking industry within our respective districts. We conduct on-site audits of our member banks and monitor bank performance and stability measures using electronic surveillance technologies. We have also launched public education programs designed to raise financial and economic literacy in our community, and we host public events and conferences on significant activities within our economy.

And we do serious economic research, designed to provide the intellectual heft for informed monetary policymaking. Our Research Department employs two dozen crack economists who study the local, national and international economies. Their work is top-notch. Few of you might know, for example, that Finn Kydland, an associate of our research team in Dallas for the past 13 years, won the Nobel Prize in economics in 2004.

We have spread our research function to our branches. In addition to tracking trends across Texas, our economists here in San Antonio and in Houston and El Paso maintain a keen interest in Mexico and the many ways its economy commingles with ours. The reason is simple: Understanding Texas' economy requires an appreciation of Mexico's. The two are joined at the hip.

I am encouraged by much of what I see on the economic front in Mexico. Its economy has been growing strongly for three years now. Preliminary estimates show that Mexico's real GDP grew at a 4.7 percent annual rate in the second quarter, and it would have been higher if so many Mexicans had not been on vacation for the Holy Week holidays. A total of 833,000 jobs were added to the formal sector in the first half of 2006, the fastest employment growth rate in nine years.

There are other positives. Inflation has been tamed. Mexico's headline consumer price index has declined to about 3 percent, its lowest level in 30 years and below the rates recently reported in the U.S. The banking sector is thriving. Low interest rates, pent-up demand for consumer credit and mortgages and financial institutions' greater willingness to lend has fueled a borrowing

boom. Mexico's banks expect loan growth of 25 percent in 2006. The peso is steady. More than a decade ago, Mexico quit the fool's errand of trying to fix the value of its currency, and a free-floating peso has been a source of stability, not only in Mexico but in South Texas as well.

What is most impressive to me, however, is how the international financial community has not retreated from Mexico, despite the turmoil and uncertainty surrounding the recent presidential election. Mexico's risk premium seems to have settled to around 120 basis points over similar U.S. Treasury bonds. Foreign investors feel, as I do, that Mexico has come to understand the value of pursuing sound macroeconomic policies, cemented by the constitutional reforms that secured the independence of Banco de México in 1994. Indeed, at the retreat we just had in Jackson Hole last weekend with our colleagues from all over the world, the governor of the central bank, Guillermo Ortiz, noted their research has concluded that had Mexico had in place the mechanisms needed to avoid the policy mistakes they experienced in the 1970s through the mid-1990s, per capita income in Mexico would be some two-thirds larger than it is today. This kind of frank acknowledgment and determination to not go back to the bad old days shows a level of sophistication that undergirds market confidence.

This is not to say there is no room for improvements in Mexico. Without serious reforms to Mexico's inadequate education system, rigid labor laws and poorly enforced contracts and property rights, the country will not live up to its full economic potential. But I believe that with each step Mexico takes toward these needed reforms, the benefits will become obvious on both sides of the border.

Another area where the researchers at the Dallas Fed are on the cutting edge involves the ongoing effort to better understand the phenomenon of inflation. To this end, we have developed a new way of measuring changes in prices that can assist monetary policymakers in assessing the direction and speed of approaching inflationary winds.

I'm going to talk at length about inflation tomorrow in a speech in Dallas, but let me give you a quick brief on the subject.

Central bankers abhor inflation. We do so viscerally; it is part of our DNA. We know, just as all of you know, that inflation will eat away at an economy's foundation by sapping the purchasing power of money and making less valuable those 5.4 billion bank notes that pass through our vaults. Once inflation gets a head of steam, it becomes difficult to bring back under control without a dose of harsh monetary medicine. Our job at the Fed is to make sure that does not happen, so the economy stands a better chance of achieving sustainable, long-term, noninflationary growth.

Every business school grad knows you cannot control what you cannot measure. This applies to inflation as well as to the operations of any factory or office. You are all no doubt familiar with the consumer price index, the CPI, which receives widespread coverage as it comes out each month. It measures the price changes for a basket of goods consumed by the typical urban American household over time.

Many economists have lost confidence in the CPI as an inflation gauge. Objections have arisen about the goods included in the basket and the statistical weights assigned to each of them. In its place, many economists and monetary policymakers look at the personal consumption

expenditure deflator, or PCE. The PCE doesn't study a hypothetical basket of goods, but measures what we actually spend our money on.

Standard PCE formulas come in two varieties. The first formula gives us the "headline" inflation number, which counts all the goods and services we buy. Weather and other temporary or seasonal conditions, however, often cause significant volatility in the prices of food and energy products, which clouds the picture when you are trying to judge longer term sustainable trends. Including these skittish items can produce a distorted picture, where real inflationary signals cannot be discerned because of statistical noise that might lead policymakers to faulty conclusions. To guard against this, analysts look at a PCE formula that excludes food and energy products, leaving what is called core inflation.

There are critics of reliance on this measure for the purposes of developing monetary policy. Many of you may have read in yesterday's *Financial Times* or heard on National Public Radio that at Jackson Hole an official of the Bank of England had some pungent comments about the wisdom of removing energy from the PCE in an era of sustained upward movement in oil prices driven by new demand and the tectonic shifts that have taken place since China, India and others got on the stick. And other central banks take a very different approach.

In preparing for our deliberations at the FOMC, I have come to rely upon what is called the Trimmed-Mean PCE Deflator. This was developed by our own economics team under the leadership of a clever fellow named Jim Dolmas.

Instead of routinely excluding food and energy, the Trimmed-Mean PCE Deflator recognizes that people have to eat, drive and air-condition their homes. Dramatic movements in food and energy prices may be a noisy distortion for econometricians, but these movements have a real impact on people's consumption decisions. To be sure, a temporary blip in the prices of any of these essential goods should not be treated as permanent and might well distort one's reading of underlying inflationary impulses. Indeed, in making policy, it strikes me as wise to be wary of any and all temporary distortions and to concentrate instead on underlying trends that condition expectations for future inflation. Thus, the Trimmed-Mean PCE sets aside whichever goods display the sharpest price movements up or down so that extreme—but temporary—price fluctuations do not obscure our vision.

The latest trimmed-mean readings are for June and suggest a base inflation rate of 2.7 percent for the previous 12 months.

The business of getting it right on inflation is not an easy task. I keep a close eye on all of the inflation measures—especially now, when high energy prices and utility bills are putting pressure on many businesses to raise prices. But I put extra weight on the Trimmed-Mean PCE Deflator because I believe it provides a more realistic picture of the price pressures in the economy and more accurately measures what conditions the operations of our economy.

I would like for you to be aware of one other item on our research agenda. I came to the Dallas Fed with a belief that we cannot truly understand price pressures in the U.S. without taking into account developments outside the country. Just as Mexico is joined at the hip with Texas and Texas is part of the United States, the U.S. economy is inextricably linked with the rest of the world. I know this viscerally as a former trade negotiator. But our linkage with the rest of the

world goes beyond just the import of goods and services and the standard textbook formula for adding net exports to the calculation of our gross domestic product. U.S. businesses source product and processes and tasks to wherever they can be secured at the lowest cost and with the greatest efficacy, whether it is in San Antonio or Shanghai. And the capital markets that businesses and governments depend upon to finance their operations are truly globalized, operating 24/7. This all affects the gearing of our businesses and the overall gearing of the U.S. economy. We can see this with the naked eye.

However, we do not really know just how this heightened interlinkage with the rest of the world should affect the making of monetary policy at the Federal Reserve. And so the Dallas Fed has taken upon itself the job of contemplating how globalization impacts us. We have only just started our work on this front, but we have begun to observe some aspects of globalization that impact economic activity and price movements on our front porch.

For example, we know that capacity utilization abroad is rising, a trend that may well have implications for our inflation rate here at home. The U.S. economy, of course, remains a Goliath, producing roughly a quarter of the world's output. So when our economy slows, it takes some steam out of the global engine. Other economies, however, have retooled and restructured to rid themselves of impediments that had been retarding growth for the past decade or more—in the case of China, since Mao took power in the 1940s, or in India, since the days of the Raj.

The changes have started to pay big dividends. The European Union economies are growing at rates not seen in some six years. For the first time in a decade, industry surveys in Japan, the world's second-largest economy, are finding capacity constraints. China's second-quarter growth came in at 11.3 percent, the fastest yet in an already remarkable decade and another indication that this emerging giant may be straining at its capacity. And India has been clocking growth rates over 8 percent.

A global boom has been under way for four years now, ignited in no small degree by the easy monetary policy that began in 2001. There was a bit of 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, eclipsing the U.S. average of 4 percent. Excess global capacity has been increasingly absorbed, even as capitalists rush to retool and expand that capacity.

Taken together, these developments suggest the relationship between supply and demand for inputs of all sorts is becoming tighter, a fact of life our businesswomen and men are encountering on a daily basis as they search the globe for the inputs they need to keep production up and costs down.

We all know about the boom in commodity prices. Let me give you another example of how global growth is affecting resource utilization. According to a shipping industry leader, some of the world's fleet of large, ocean-going ships are being pulled into duty moving bulk cargo from one Chinese port to another. It may be that only 1 or 2 percent of the fleet has been reassigned to China, but daily shipping rates have been rising at a time of the year when they're usually softening. They are roughly two times what they were a year ago. It now costs more for importers to ship goods to the U.S., an illustration of how global growth can impact prices here at home.

We are going to see more of this, not less, as the rest of the world continues to adapt.

Of course, economic theories and models dealing with global influences have been around for hundreds of years. We have David Ricardo, Francis Edgeworth, Paul Samuelson and many others to thank for setting the economics profession on an ever-improving path for better understanding the global aspects of economics. I would posit, immodestly, that the models and analytical tools used by the Federal Reserve are some of the most sophisticated and practicable ever developed. The problem is that our tool kit needs to continue expanding to deal with today's rapidly changing manifestation of globalization. Tremendous complexity is required to capture the sophisticated working and resulting impacts of the changes we are experiencing, and we need to continue to push the envelope in order to fully understand how to make monetary policy in the world that is and will be rather than the world that was.