

Monetary Policy in Uncertain Times (With a Salute to Julius Squeezer and Mr. Bean)

*Remarks before the Progress & Freedom Foundation
Aspen Summit 2008*



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Aspen, Colorado
August 19, 2008

The views expressed are my own and do not necessarily reflect official positions of the Federal Reserve System.

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I am grateful for the invitation to speak to such an impressive gathering of technologically savvy people. I want you to know what a tremendous sacrifice it is to be here in the Rockies, instead of sitting at home like a hard-boiled egg in the steamy summertime cauldron of Texas. Mark Twain famously said that everybody talks about the weather but nobody does anything about it. Well, I have done something about it: I've come to Aspen. Bret [Swanson], thank you for inviting me. And thank you for that kind introduction.

Last night I had the pleasure of talking about China at dinner with a group of you. Today, I would like to talk about the issues we face at the Fed as we work to create the monetary conditions for achieving sustainable, noninflationary employment growth in very uncertain times. But first, given the interests of this group, I want to tip my hat to information technology and quickly tell you about the IT side of the Federal Reserve.

Most of what you read about the Federal Reserve focuses on monetary policy, which I will turn to shortly. Yet, in addition to setting the base interbank lending rate, known as the fed funds rate, the Fed operates a pretty complex business.

We meet the banking system's need for cash. The 12 regional banks store currency and coins in massive vaults and use 132 machines to count and sort currency at a rate of 86,000 bills an hour, day in, day out. We clear checks. Last year, we processed 5.8 billion paper checks and 4.1 billion electronically imaged checks. We moved \$5 trillion *per day* between financial institutions to settle their accounts.

And we extend credit. Over the past eight months, we have lent considerable amounts through the discount window and other facilities created to provide liquidity and alleviate strains in the financial system. At its peak, credit outstanding approached \$180 billion and currently stands at about \$165 billion. This is on top of our currency swap agreements designed to provide more than \$60 billion of liquidity to European banks. In addition, we have made available large amounts of Treasury securities to primary dealers.

None of this would be possible, of course, without sophisticated information technology and systems. As Bret mentioned, in addition to serving as president of the Dallas Fed, I chair the IT Oversight Committee for the Conference of Presidents of the 12 regional banks.

Let me give some idea of the dimensions of our Systemwide IT needs. Our mainframe processing power totals nearly 9,000 millions of instructions per second, or MIPS. We have in excess of one petabyte, or one *quadrillion* bytes, of data storage capacity. Across the System, we have about 4,500 servers and 24,000 desktop computers, laptops and mobile devices. Our national networks support nearly 3,000 high-bandwidth circuits that reach about 1,500 end points, both internal locations and external customers. To keep this technology functioning, we employ 3,600 IT professionals. Our annual spend on IT is roughly \$1 billion.

To say that it is a special pleasure to spend a couple of days surrounded by IT professionals—*who aren't trying to sell something*—would be an understatement. I look forward to learning a lot more from you these next few days than you will likely learn from me today.

Let me turn to the current predicament facing monetary policy makers. Keep in mind that what I am about to say reflects my own opinions and experiences. I do not speak for the Federal Reserve or the other members of the Federal Open Market Committee (FOMC), our main policymaking group.

We are in the midst of a fierce correction from a prolonged period of indiscriminate behavior in the credit markets, a surfeit of home building, a global avalanche of cheap labor and correspondingly cheap imports, and other unsustainable financial and economic activity. If you were a yachtsman, you would say that we sailed the economy along in a following sea for a long time; now we are navigating force 10 seas. Everyone is battening down the hatches and reefing in their sails. Worldwide, creditors are tightening their standards and consumers and businesses are correcting their courses.

The correction in the housing market has yet to find its bottom. Credit markets remain tempestuous. The price of the Chinese and other emerging-country labor we came to rely upon to hold costs down is rising; the cost of imported goods, and of goods and services overall, is rising too, driven in part by demand from the newly rich consumers in those emerging countries. U.S. consumers are being hammered by declining real income, U.S. savers and investors are being squeezed by negative real interest rates and U.S. companies' business margins are under pressure.

All these forces have conspired to constrain economic growth. My best guess is that our \$14 trillion economy grew faster than the 1.9 percent annualized rate initially reported for the second quarter, thanks to exports and prudent inventory management. But I expect U.S. economic growth will decelerate to a snail's pace, if not completely grind to a halt, in the second half of this year. Indeed, we may see the slowdown extend into 2009 as the excesses that drove the housing markets unwind before the economy can again gear up to cruising speed. Then, as 2009 unfolds, it is quite possible that the economy will resume a more normal growth trajectory.

Congress charged the Federal Reserve with creating the monetary conditions for sustainable, noninflationary employment growth. We are sorely aware of the present risk to job growth. At the same time, we have to be keenly aware of the consequences of our actions for inflation. We have a dual mandate—the operative words modifying growth are “sustainable” and “noninflationary”—and we are duty bound to deliver upon it.

A clear-eyed observer would, I believe, look at the facts and say the Fed has done its job on the growth front. The FOMC has taken aggressive action to stabilize the credit markets and has not been shy about cutting the fed funds rate. It would likely appear to that clear-eyed observer that these initiatives have paid dividends: The U.S. economy has continued to grow. In fact, but for the fourth quarter of 2007, the numbers have thus far been better than what most pundits expected, though everyone and his sister, including me, contemplates a more anemic outlook going forward. (The old hedge fund manager in me tells me that when everyone and his sister

shares a view—when there is consensus on the street—it is usually wrong, but I still think the growth outlook for the next quarters is unpleasant.)

As for the “noninflationary” part, the observer would take heart from the recent price reversals that have taken place in the oil and commodity markets. But her brow might knit up a bit as she dissects the Consumer Price Index (CPI) data released Thursday. That report said that consumer inflation increased at an annualized rate of 10.3 percent in July and that, year over year, consumer prices have risen 5.5 percent. She might also note that roughly 25 percent of our Consumer Price Index is a theoretical construct to capture the cost of shelter called “owner’s equivalent rent” and conclude that the effective cost pressure on consumers and business operators is actually higher than the headline number.

And our clear-eyed woman would note that even as economists remove energy and food from the CPI to eliminate the “noise” of those volatile items, the underlying, or “core,” inflation measure is also drifting upward on a year-over-year basis, indicating that inflationary pressures are spreading beyond energy and food prices. Were she an economics wonk, she might further note that the “trimmed mean” CPI that the Cleveland Fed calculates—another way to parse the data to look for the underlying trend—posted a one-month gain of 7.2 percent, something it has only done once before, in 1991.

It is important to remember, however, that the July CPI is history. Data are the past. The question that the FOMC must wrestle with is: What will occur on the inflation front going forward?

In an op-ed in the August 7 issue of the *Financial Times*—perhaps the world’s most renowned newspaper before the recent surge of the *National Enquirer*—one of the world’s most respected economists, Martin Feldstein, wrote that the Federal Reserve “is prepared to gamble that the weakness in U.S. employment and the general decline in economic activity will prevent a wage-price spiral without further increases in the interest rate. If food and energy prices remain at today’s level and wage costs do not accelerate, the overall consumer price index inflation will decline by next year....”¹

Were I rewriting that paragraph, I would purge the word “gamble” because the thought of any semblance of gambling at the Fed is contrary to my experience. The FOMC—the 16 dedicated individuals whom I have the great privilege of working with under the leadership of Ben Bernanke—does not gamble. To be sure, we are aware any economic outcome is subject to probabilities and chance. But the verb “gamble” carries the connotation of squandering away hard-earned capital. The earnest men and women who make up the FOMC have no intention of squandering the bedrock capital of a central bank: the confidence the public places in our hands to keep inflation at bay while we work to bolster economic growth and restore the financial system.

That said, you do not have to be a gambler to subscribe to Dr. Feldstein’s scenario. The markets in commodities, like those of stocks and bonds, are manic-depressive mechanisms and overshoot on the upside as well as on the downside. One could reasonably deduce from recent price reversals in oil and food prices that they overshot on the upside and that their price run-up was a

¹ “The Crisis: A Tale of Two Monetary Policies,” by Martin Feldstein, *Financial Times*, Aug. 7, 2008.

one-off development. If you subscribe to this argument, you envision a process not unlike that of a python digesting dinner: It visibly moves through the system, creating some moments of discomfort—in this case, a temporary inflationary bulge—but is processed in reasonable time and done with.

Because this is a serious speech, I will refrain from telling you about my neighbor in Dallas who had a pet python named Julius Squeezer. But I will tell you that I learned much from watching that python over the years: He was an efficient processor of most anything he swallowed, although there were times when he had to be taken to the vet to be treated for indigestion.

It is tempting to deduce from the recent reversal of commodity prices—in particular, energy prices save coal—that the discomfort manifest in headline inflation numbers that we broached in July is passing through the system and is being squeezed out by slowing economic growth. This is certainly a plausible economic scenario. Weakness in the U.S. and other advanced economies will mitigate inflationary pressures, rendering them a temporary inconvenience. In the parlance of central bankers, the recent run-up of headline and core prices represents “noise” rather than underlying “signal.” Given that the Fed focuses on signals about intermediate and long-term sustainable, noninflationary employment growth, rather than short-term expediency, it is in keeping with our charter to give considerable weight to this scenario.

I note that we would not be alone in doing so. This is the conclusion that the Bank of England has been most public about as it recently ceased raising its policy rate. I have the highest personal regard for Governor Mervyn King and especially for his deputy, a member of the distinguished advisory board of the Dallas Fed’s Globalization and Monetary Policy Institute, the convivially named Mr. Charlie Bean. I did note, however, that in reaction to the recent release of the Bank of England’s analysis, the *Financial Times* on Thursday wrote an especially harsh editorial titled “Shoot the Doves,” which concluded with these words:

“The ongoing disruption in credit markets is acting as a brake on the economy ... because credit is less available and it costs more Keeping rates on hold looks right for now.”

“But,” the editorial went on, “... the Bank must also worry about its credibility: if the public ceases to believe that it will bring inflation back down, then it will become much harder to do so.”²

This risk applies to the Fed just as much as it does to the Bank of England. We cannot afford to gamble away our credibility. That is why the FOMC has made it clear in its recent statements that we are keenly monitoring inflationary impulses. In doing so, we must be wary of a second possible scenario, one that differs from the one summarized by Dr. Feldstein.

This second scenario is less felicitous. It acknowledges the manic-depressive nature of commodity markets and recognizes that it was inevitable that price peaks would give way to

² Editorial comment, “Shoot the Doves,” *Financial Times*, Aug. 13, 2008.

price valleys. But the scenario envisions the possibility that rather than passing through the python, the recent burst of cost-push inflation is giving the beast digestion problems that might manifest themselves in the form of a lingering inflationary fever.

Many micros make a macro. The economy is the sum of its parts. Jobs are created by, and prices are set by, microeconomic units, by businesses—thousands upon thousands upon thousands of them.

Business operators do what they are paid to do—grow their bottom lines in good times and protect them in bad. Presently, it is difficult to grow top lines in the U.S. domestic market because demand is anemic. And yet it is increasingly difficult to protect bottom lines because critical components of the cost of goods sold have been rising. What comes in through the back door of most businesses has been rising, driven by fuel and transportation and other input costs. Labor costs at home have been restrained. But labor costs in other places where American companies produce and source goods, particularly China, have been rising dramatically.

Here is where the globalization process hits the inflationary road. Not long ago, the newfound desire of the Chinese and Indians and former Soviet satellites and the Brazilians and others to hop onboard the capitalist ship led to a flood of cheap labor and low-cost goods and outsourced services. Our economy experienced the most pleasant of tailwinds, propelling it forward while restraining inflation. Now that these countries are climbing up the income ladder and consuming more of what we consume, we are facing a bracing headwind from the very same sources that previously helped our economy sail along.

The Chinese Ministry of Human Resources and Social Security reports that in the first half of this year, wages in urban areas, where most U.S. and foreign firms make or assemble products, rose 18 percent. And, as any U.S. firm operating in China will tell you, recent stepped-up enforcement of job rules has made China an even more expensive place to operate.

I cannot tell you how much we should weigh this particular cost component. Nobody knows the answer to how this impacts cost structures here at home. But this much is clear: The tailwind that was holding labor costs at home hostage to the threat of outsourcing production to China has been significantly mitigated. Any garment producer or hospital equipment maker or high tech assembler operating in China can testify to that.

In addition, as income levels have risen in the emerging countries, so has their appetite for raw materials and basic necessities. China, for example, now has 37 million cars; the press reports that they will reach 50 million cars in 2009, on their way to some 100 million in fairly short order. Fueling that fleet contributes to the country's rising demand for oil, now largely satisfied by imports of 8 million barrels of oil a day. As China grows, she will require still more oil. How much? Well, here is a simple calculation you can do. A week ago, the *Wall Street Journal*³ pointed out that the Japanese consume 14 barrels of oil per capita each year, whereas the Europeans consume 17 and the Americans 25. If China used the same amount of oil per capita as parsimonious Japan, China's consumption would total more than 18 billion barrels a year, an amount that dwarfs our consumption of 7.5 billion barrels. Add that to new demand stemming

³ "U.S. Retools Economy, Curbing Thirst for Oil," by Justin Lahart and Conor Dougherty, *Wall Street Journal*, Aug. 12, 2008, p. A1.

for oil from the billion people of India, the new members of the European community, an increasingly prosperous Brazil and so on, and extrapolate these new demand pressures for oil to wood or steel or food oils or animal proteins or anything else that growing economies consume, and you begin to get the picture of what keeps a forward-thinking businesswoman or man up at night.

If you layer a Chinese wage-price spiral and demand-pull forces on top of the shiver sent up the spine by sudden price increases in most raw materials this past year, you might forgive U.S. business operators—the women and men who do the spadework to create the employment we seek to encourage through prudent monetary policy—for doing what rational managers do to protect their margins. At bedtime, they may pray on their knees, thanking the market gods for the recent correction in prices for oil and gas and other materials. But during the day they are doing two things: (1) They are cutting whatever costs they have control over by reducing head count, stretching out inventories, pulling back on capital expenditures, and so on; and (2) they are seeking to pass through costs that are out of their direct control—the ones that are coming through the back door—by raising prices of the goods and services they ship out the front door.

On August 1, for example, the *Wall Street Journal*⁴ reported that Unilever offset cost pressures by raising the average price of its thousands of products by 7.4 percent, despite having seen its volume of goods sold slip by 0.5 percent in the second quarter. The article added that Unilever's CEO "didn't plan to make any major changes."

Neither, according to public reports, do companies as varied as Dow Chemical, Frito-Lay, Kodak, McDonald's, American Airlines and the various 99 cent stores. Even Bloomberg, the great electronic purveyor of financial information and news, is protecting margins by raising prices: Last week, they notified their customers, including the Dallas Fed, they would be increasing prices by 6 percent on December 1. It was noteworthy that in releasing his company's earnings for the second quarter, the CFO of Wal-Mart said suppliers were asking for price increases at a "higher level than I can remember since I began at the company."⁵

This behavioral response, were it to become even more widespread, leads to unpleasant consequences for me and my fellow policymakers. Unless the python that is the U.S. economy can quickly pass the recent burst of cost-push pressures, we risk a reinforcing spreading of inflationary impulses and expectations. Should this happen and the Fed were to fail to address it, we would run the risk of losing the public's confidence in our ability to constrain inflation. Then the great editorial writers in this country, to say nothing of Congress and the American people, will be calling for all of us—doves and hawks alike—to be shot (metaphorically speaking, of course).

⁴ "Unilever's Earnings Fall as Price Increases Hurt Sales," by Aaron O. Patrick, *Wall Street Journal*, Aug. 1, 2008, p. B3.

⁵ "Wal-Mart Net Up 17% on Rebates, Bargain-Hunters," by Ann Zimmerman, *Wall Street Journal*, Aug. 15, 2008, p. B1.

Thus, I urge you to observe closely the noble python. He might digest and dispatch the recent inflationary surge, or he might gag on it. It is too early to tell. And until we have a clear sense of what will prevail, monetary policy makers must remain poised to act if slowing growth fails to contain inflationary pressures.

Thank you.