

# Economic Challenges

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*Remarks before the Greater Houston Partnership*



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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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Richard W. Fisher

Thank you, Doug [Foshee, CEO of El Paso Corp.]. I am most grateful for this opportunity to address the Greater Houston Partnership. This great metropolis houses a key branch of the Federal Reserve Bank of Dallas, overseen most ably by Admiral Bob Smith from that splendid Michael Graves-designed building on Allen Parkway. I want to tell you that that building was delivered on time and on budget thanks to Leo Linbeck's good work and Bob's watchful eye. Of course, we would expect no less from a former chairman of the Federal Reserve Bank of Dallas. I salute you, Leo. The great entrepreneur Norman Brinker told me when I first came to Texas in 1973 that "it is nice to be important. But it is more important to be nice." Leo is the embodiment of being both nice and important. And so is Bob. Thank you both for your exemplary leadership.

This is an exciting period in American history. We have two able presidential candidates vying for the highest office in the land during a period of enormous economic challenges. The central bank of the United States—the Federal Reserve—is chartered by Congress to conduct monetary policy so as to engender maximum sustainable noninflationary growth. To do so, the Federal Reserve and its officials and staff must remain scrupulously nonpartisan and nonpolitical. When you enter the temple of the Fed, you check your political affiliation and interests at the door. We favor no party and no candidate. We treasure our independence.

I say this up front so as to politely ask you to pardon me if I dodge any questions you might be tempted to ask about the presidential campaign at the conclusion of these comments.

That said, I thought I would sketch out for you the circumstances the new president and the new Congress will be confronted with when they are elected.

Two weeks ago, I spoke in Aspen and described the current domestic economic predicament like this: The housing market has yet to find its bottom; credit markets remain tempestuous; creditors are tightening their standards; consumers and businesses are battening down the hatches and reefing in their sails. The prices of Chinese and other emerging country labor and inputs we have come to depend on have been rising; business margins are being squeezed; consumers are suffering from declining real incomes; savers and investors are confronted with negative real rates of return. These are hardly fortuitous circumstances.

In Admiral Smith's parlance, having sailed the economy along for years in a tranquil following sea, we are now navigating Force 10 conditions. To be sure, on the growth front we have managed to make better headway than most everyone expected under the circumstances: To everyone's surprise, our \$14 trillion economy grew at a 3.3 percent annualized rate last quarter, meaning that the American economy produced almost \$29 billion more in the second quarter than it did in the first.

That said, looking off the bow, I see nothing on the horizon that would lead me to conclude anything different than what I articulated in Aspen: The data received since then on personal

consumption expenditures, real capital expenditures and construction show the third quarter off to a weak start, although yesterday's manufacturing numbers were a nice surprise on the upside. I think it is very likely we will suffer anemic growth for the current and perhaps the next couple of quarters. But I want to lay down a caveat: What bothers me is that this is a widely held view. I learned over the years as a market operator that the consensus view is almost always wrong. American entrepreneurs and business leaders are ingenious in figuring out how to overcome obstacles that might befall lesser capitalists. Still, I think it likely that our movement through the muck and the flotsam and jetsam of the credit and housing debacle will be sluggish, and it may take some time into 2009 for us to get the economy back up to a snappier cruising speed.

As to the inflation outlook, there appear to me to be even odds that one of two scenarios will obtain.

The first calls for slowing domestic and economic growth to dampen the inflationary surges we have seen of late. This scenario banks heavily on the recent price reversals in energy and other commodity prices and takes succor in the fact that, but for the oil patch and construction sectors in Texas and elsewhere on the Gulf Coast, domestic wage pressures have been tame, mitigating the odds of what inflation watchers most fear: a self-reinforcing wage-price spiral in response to upward pressures in the cost of living.

The other probable scenario assumes that rather than passing through as a "one-off" event, there is some spreading of the inflationary pressures we have been experiencing. According to this scenario, the inflationary scare we experienced of late infiltrates the mindset of consumers and business operators alike, and they begin to change their behavioral patterns accordingly.

In my most recent series of speeches, I have enumerated several examples of the actions taken by a wide swath of businesses to recover their costs by raising prices. In the interest of time, I will not repeat them here. All you need to do is look at Tuesday's *New York Times* article titled "Despite Lower Oil Prices, Little Relief for Consumers" to get the picture.<sup>1</sup> After companies have had their margins gutted by dramatic rises in their cost of goods sold, one can envision them being a little skeptical about the durability of recent price retrenchments in the commodities markets and taking advantage of every opportunity to buy protection from being victimized again. Under this scenario, consumer prices prove sticky on the downside.

The jury is still very much out as to which scenario will obtain. The most recent inflation reports are not particularly encouraging. On Aug. 29, the personal consumption expenditure (PCE) numbers for July were released. The "headline" inflation rate for the PCE came in at an annualized pace of 7.9 percent. This is better than the 9.3 percent we saw for June. And yet if you link May, June and July together, but for the immediate aftermath of Hurricane Katrina, you have to go back to 1982 to find a worse three-month stretch for consumer price inflation.

Moreover, if you break out the component details of the PCE, you would notice that of the expenditure-weighted items—there are over 200 items in the basket whose price movements are tracked—85 percent increased in price, with 48 percent rising faster than a 5 percent annualized rate, up from 33 percent in the June period.

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<sup>1</sup> "Despite Lower Oil Prices, Little Relief for Consumers," by Louis Uchitelle and Michael M. Grynbaum, *New York Times*, Sept. 2, 2008.

As every economist worth his or her salt will tell you, you have to be careful to sort out the “noise” from the “signal” in all these data to discern the underlying trend. Taking all our various price measures together (both PCE-based and CPI-based), here is what you can say: It is pretty clear that trend consumer price inflation has accelerated over the past few months.

Less clear, however, is the duration of this acceleration. The thing you have to constantly bear in mind is that data represent the past. It is history, not the future. To discern the future course of economic phenomena you have to keep your ear to the ground, in addition to consulting econometric models.

I repeat that while it seems pretty clear that economic momentum is slowing, the jury is out on whether lesser momentum will be sufficient to translate into relief on the price front over the intermediate to longer term. In East Texas parlance, “It might could, but it mightn’t”; it most definitely has not thus far.

In formulating my input into the upcoming discussions of the Federal Open Market Committee (FOMC), I am going to be listening very closely to my contacts in the business community as to their perception of the direction of prices while carefully studying the entrails of the models and other econometric tools employed by our able economists at the Dallas Fed and the Board of Governors.

I will say this much and then shift to more felicitous subjects: Within the aviary that is the FOMC, I am viewed by outside analysts and by the press as being the “most hawkish” on inflation, sometimes referred to in [Larry] McMurtry-esque language as “The Lonesome Hawk.” Neither I nor what commentators describe as my “less hawkish” or “dovish” colleagues feel that this convenient nomenclature does justice to our approach to policy. The one thing we do not wish to become are pigeons. So we work double time, overtime to try to deliver on our mandate to provide the monetary conditions for maximum sustainable noninflationary employment growth. And doing so means we must be wary of risks on both the growth and inflation fronts.

So much for fowl language. I want to turn now to some good news that also comes from a close analysis of the recent numbers—a ray of sunshine, if you will, peeping through the dark clouds. I refer to our growing prominence as a global service provider.

Americans are champion exporters. In 2007, we sold \$1.1 trillion in goods to satisfy foreign consumers, ranging from one of our biggest exports, semiconductors, to soybeans to airplanes to pharmaceuticals. The shipment of goods is vital to the future of Texas, as we are the largest exporting state, having recently pulled ahead of California, in no insignificant part due to the great Port of Houston. But a close study of the numbers makes clear that as we move forward in time, our nation’s comparative advantage in global markets increasingly lies in the service sector.

In 2007, Americans sold nearly \$500 billion in services to foreign customers, more than the combined total of the two next largest service exporters, Germany and Great Britain. The most recent data show service exports are running about 17 percent ahead of last year’s pace and have been growing at a rate of 12 percent per annum for the past five years.

Houstonians and Americans are top-notch competitors in most all high-value-added service sectors. In industrial engineering, U.S. exports exceed imports by nearly 24 to 1. Our ratio in the distribution of film and television programs is 13 to 1. In both medical care and in construction services, areas where Texas hits the ball out of the park, the edge is 10 to 1. We have an 8 to 1 edge in information processing. I could lull you to sleep with a recitation of each and every service sector, so let me just say that in over three-quarters of all trade categories classified by the Department of Commerce, the United States maintains significant comparative advantage relative to the rest of the world. We run a trade surplus in services.

The consensus view among leading economists is that growth of the global economy is slowing presently. Yet, even if the global economy slows in the immediate future, over time we will continue to benefit from our comparative advantage in providing services. Let's look at the two countries that everyone seems to be focusing on: China and India.

Our chief economist at the Dallas Fed, Michael Cox, calculates that China will add \$116 billion to global demand for medical care in 2008. India will contribute an additional \$25 billion in demand. Together, these two countries' increase in demand for medical care in just one year will be more than four times that of the United States.

Or look at recreational services. In the U.S., we add roughly \$23 billion a year in spending on recreation. In China, one year's added demand comes to \$79 billion, and in India, \$16 billion.

We have enormous capacity to sell into those and other more-developed markets American services that are head and shoulders above the competition. Why? Because we have the right stuff. Over a third of our workers have earned at least a college degree, tops in the world. A good many of them hold services jobs and are among the world's most productive service workers.

Herein lies a challenge that goes above and beyond monetary policy. If we want to keep growing the United States' share of the global market for services, we must resist the siren call of protectionism. We cannot expect to have our service-sector team rack up points on the trade scoreboard if we pull out of the game and retreat into a defensive crouch in the other sectors of our economy. I hope both presidential candidates and both political parties will bear this in mind.

We must always remember that the ultimate source of our comparative advantage in providing high-value-added services and brain-intensive goods like semiconductors and pharmaceuticals to the rest of the world is the three-pound machine that sits on top of every American's shoulders—the American brain.

We cannot succeed in a globalized world without superior educational institutions. You all have heard the arguments a million times and I won't repeat them here, except to ask you to consider two aspects of the clear need to plow an enormous amount of money and effort into continually making for the best-educated workforce in the world.

First, if Texas is to become the brightest star in the American economic sky, we simply must drive our universities to higher levels of excellence. As Houstonians, you should be proud of the fact that Rice was ranked by last year's *U.S. News and World Report* survey as 17th in the nation for overall excellence, above Vanderbilt and University of California–Berkeley. As Texans, you should be less proud that, according to that survey, six campuses in the University of California

system outranked the University of Texas at Austin, which *U.S. News* ranks at 47th. Or that Texas A&M ranked 64th, SMU 66th and Baylor 76th.<sup>2</sup>

There are numerous other measures of “brain prowess,” and on almost all fronts the point is clear: While we can be justifiably proud of Rice, we should be making every effort to bring our other academies up to the highest standards in order to secure our future. By almost any measure, we are falling short on this front, be it the number of faculty members Texas universities have in the National Academy of Sciences or the National Academy of Engineering or the Institute of Medicine or as winners of Nobel prizes or—that great arbiter of academic excellence—as claimants to federal R&D dollars.

David Daniel, the president of UT Dallas, likes to point to an exemplary study done by economists with BankBoston in 1994 about MIT alumni.<sup>3</sup> That study showed that more than 4,000 high-value-added companies employing 1.1 million people were founded by MIT grads. In 1994 those companies grossed \$232 billion. By contrast, in 2005, Dallas–Fort Worth, a region responsible for one-third of our state’s economic output, reported a gross metropolitan output of \$285 billion. The Austin–Round Rock MSA reported a gross metropolitan product of \$66.2 billion that same year. In 1994, MIT alums produced approximately as much as the entire DFW metroplex 10 years later and three and a half times as much as our state capital.

Texas is a mighty economic machine. We cannot expect to stay mighty in a knowledge-driven, service-sector-powered world unless we see to it that our major universities achieve the standards of a Rice University or an MIT.

The second point is that we cannot expect to do so unless we develop a sensible approach to immigration. Most of the time, the discussion of immigration focuses on the poor and huddled masses that wish to come to our economic shores, like my parents did 70 years ago, as did the ancestors of most every person in this room. But there is another side to the immigration issue that is very much as important.

Consider two illustrative facts: Fifty-five percent of the engineering master’s degrees awarded by major Texas universities went to foreign citizens. Seventy-five percent of engineering Ph.D.’s from those same universities also went to foreigners.

Now consider this: These same skilled immigrants must wait up to 10 years for a green card when they are lucky enough to get an H-1B visa first. While the U.S. is busy turning away the best and the brightest, other governments are thinking proactively about how to take more of them in. The Australian government recently announced they will seek to increase their pool of skilled foreign workers by 30 percent. The European Union is considering a skilled immigration program similar to our H-1B visa; some of the original EU nations are already benefiting from influxes of skilled migrants from the new member nations in Eastern Europe.

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<sup>2</sup> “America’s Best Colleges 2009,” *U.S. News and World Report*,  
<http://colleges.usnews.rankingsandreviews.com/college/national-search>.

<sup>3</sup> “Thoughts on Creating More Tier One Universities in Texas,” by David E. Daniel,  
[http://www.senate.state.tx.us/75r/Senate/commit/c535/20080723/David\\_Daniel\\_Tier\\_One\\_Universities\\_Report.pdf](http://www.senate.state.tx.us/75r/Senate/commit/c535/20080723/David_Daniel_Tier_One_Universities_Report.pdf).

So where do you think these wonderful students that we have educated in universities subsidized by taxpayer money and private endowments are going to go?

This is nonsense. It is as though we went out and spent hundreds of millions of dollars to drill exploratory wells and then when they were proven, simply gave all the oil or gas away to others. We need an immigration policy that encourages the cream of the crop of foreigners to stay here and help us build our economy and stay ahead of the competition in the high-value-added service sector.

One of my more erudite friends puts it this way: Pretend the U.S. is an NFL franchise. Everyone wants to play on our team; we could have every first- and second-round draft choice we wanted if the rules allowed it. And yet we give them away to other teams.

I hope you good Houstonians will do all you can to influence the lawmakers of our land to redress our nonsensical immigration policy.

Enough serious stuff. I want to come back to Leo and Bob. Remember I told you that they brought our branch building here in on time and on budget? Well, my wife, Nancy, and I are doing a major remodeling of our house. On Sept. 8, Nancy and I will celebrate our 35th wedding anniversary. I can honestly tell you that in those 35 years—three and a half decades—we have never—not once—had an argument ... that I haven't lost. This record remains intact with the rebuilding of our house. So, Leo and Bob, you could win one for the Gipper just this once if you would share your secrets with me. I promise to keep them to myself.

Thank you all. I would be happy to avoid answering your questions now.