# Remarks Before the 55th Annual Meeting of the North Dallas Chamber of Commerce

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Thank you, Ralph [Babb] for that kind introduction.

A little over a year ago, the nation was staring straight into the jaws of economic ruin. The Federal Reserve stepped into the breach and did what central bankers are called to do: We assumed the role of lender of last resort, enacting a sequel to the playbook written by the Bank of England over 180 years ago following the Panic of 1825. We opened the flood gates and lent freely, instituting unconventional measures to keep the financial lungs of the global economy from collapsing.

In doing so, we took enormous risk with our reputation and with our balance sheet, expanding it from north of $800 billion before the crisis to $2 trillion today. We knew full well that this would lead to a gnashing of teeth about the long-term consequences of our actions, not the least of which is the potential for all the money we have pumped into the economy to spark an inflationary conflagration once its gears start to mesh again.

I am going to talk to you today, first, about where the economy and inflation now stand and then say a few words about the opportunities that lie before us as Texans as we move on down the road.

The long and short of it is that there are presently some signs that the economy is stabilizing and even reviving in certain areas, despite mixed signals. Financial markets are continuing to improve; household spending is stabilizing but remains constrained by ongoing job losses, sluggish income growth, lower housing wealth and tight credit; businesses are making progress in aligning inventories, though sales are still anemic and CEOs are continuing to cut back on fixed investment and payrolls. Given both the monetary accommodation we at the Fed have put in place and the stimulus of fiscal policy, it is now reasonable to expect a gradual resumption of economic growth in a context of price stability.

The operative words in that sentence were “gradual” and “in a context of price stability.” So, just what are the prospects for economic growth? And what is the outlook for prices?

For the past four years, I have personally surveyed 30 or more chief executives of key companies in a broad array of sectors before every Federal Open Market Committee meeting in order to get a read on how they are positioning their enterprises.

These operators of our economy—private-sector operators whose teams decide what to purchase, what to produce and how many workers are needed to turn inputs into products and sales—are still suffering from shock induced by the trauma of the crisis. I would say they are suffering from “post-traumatic slack syndrome.”

Until the summer of last year, businesses were emboldened by a prolonged period of ready money and robust global demand. They were geared toward the expansion of plant, equipment and payrolls. At the same time, inflationary pressures were building. Businesses took every measure possible to boost their top lines by passing on rising costs through higher prices. As we entered the summer of 2008, the inflation data exhibited frightful tendencies. Of the 178 items in the consumer's basket used to measure PCE, 77 percent were rising, and the number rising above 3 percent per annum was the highest we had seen in nearly two decades.

There are limits to the costs that can reasonably be passed on to consumers without damaging top-line revenue performance. Thus, simultaneously, businesses worked like beavers to preserve their bottom lines by controlling the costs of goods and services they sold, shifting their management models and budgeting accordingly.

Then they experienced a traumatic shock. Demand imploded. The equity and fixed-income markets seized up. Bank credit evaporated. The growth of the global economy hit a wall. Whereas just over a year ago managers were coping with a pervasive scarcity of inputs and escalating prices, there is now an abundance of almost every input and output and no pricing power. There are too many ships at sea; too many rail cars; too many airplanes and trucks; too many homes; too many hotels and apartments and office buildings; too many retail stores and malls and convenience stores; too much oil, natural gas and corn; and, according to *Wall Street Journal* reports last week, even too much champagne and bottled water.[1]

And yes, thank you Lord, we have finally come to realize there are too many lawyers.

In almost every sector of the economy—save for nonelective medical services and a few basic commodities being hoarded by the Chinese—the CEOs I survey are struggling to cope with excess capacity and slack.

Businesses trying to sell products and services feel they are pushing on a string and are adjusting their behavior accordingly. To maintain sales volumes and clear inventories in the face of weakened demand, they are cutting prices. In the fourth quarter of last year, we began to see an upward shift in the number of items falling, rather than rising, in price. In the July data recently released, almost 50 percent of the items in the PCE basket—weighted either by simple count or expenditure—were falling in price. Small wonder that headline inflation was negative over the year ended in June.

And top lines have evaporated. In this most recent quarter, for example, the 376 nonfinancial companies in the S&P 500 reported a nearly 20 percent decline in top-line revenues. This is the third sales decline in a row—the first time we have seen this since 1965.

The new numbers tell me two things. First, for the immediate future, the risk to price stability is a deflationary risk, not an inflationary one. And second, businesses will continue to run tight budgets as they try to preserve profit margins while operating in the absence of pricing power with the pervasive difficulty of expanding top-line revenues in the face of weak demand. They

[1] "Bottled-Water Price War Heats Up as Demand Falls," *Wall Street Journal*, Aug. 31, 2009, p. B1, and "As Champagne Fizzles, Makers Squash Supply," *Wall Street Journal*, Sept. 3, 2009, p. B1.

will continue to focus on cost control, most painfully by shedding workers and driving those who remain on the payroll to higher levels of productivity.

All of which means that we are likely to see a prolonged period of sluggish economic performance and uncomfortably high unemployment as businesses reallocate capital and labor to fit the new economic landscape.

The needed reallocation of labor and capital has been, and will continue to be, impeded by financial markets. Although substantially improved from last fall—due in significant part, I would argue, to the work of the Federal Reserve—markets are still a long way from having normalized. We know from our own experience and from the experience of other countries that financial headwinds like these take years to abate.

To offset those headwinds, fiscal authorities have stepped forcefully into the breach, putting in place a massive stimulus effort. They have done so with the intent of limiting the damage to disposable income from unprecedented declines in wage and salary income—while trying to goose up capital expenditures on infrastructure.

If you go back to the rudimentary formula taught in high school economics to account for the makeup of GDP—consumption plus investment plus government expenditures plus net exports—the "G," or government, variable is receiving enormous emphasis, while "C" is flaccid, "I" is hesitant and net "X" is tentative. At the present rate, federal, state and local authorities are expected to spend, net of intragovernmental transfers, $5.4 trillion in 2009—just under 40 percent of expected GDP.

The problem is that government stabilization measures come with a real long-term price tag: higher tax rates, greater national indebtedness and the prospect of higher interest rates and the debasement of the dollar driven by the government's issuance of massive amounts of debt. These long-term costs of a larger government limit the American people's willingness to rely on the public sector to drive overall economic growth. A fiscal gag reflex ensues, and the public-sector option looks less and less attractive as anything other than a temporary source of growth.

The major challenge facing U.S. fiscal authorities is meeting the need for near-term economic stimulus while pursuing a practicable plan to stabilize the government's debt-finance obligations. The secretary of the Treasury is doing his level best to reassure investors—both overseas and here at home—that the programs put in place by the Obama administration and the Congress will work their magic and then be gradually withdrawn as the economy gets back into stride. But this is no simple task. It is now common knowledge that deficits are growing at $3 million per minute and will accumulate to some $9.1 trillion over the next decade. And our fiscal predicament is compounded by the embedded unfunded liabilities of Social Security and Medicare. By our calculation at the Federal Reserve Bank of Dallas, the present value of the unfunded debt of these two entitlement programs has reached $104 trillion, with $88.9 trillion of that due to Medicare alone.

The legendary actor Errol Flynn is reported to have quipped that his problem lay in "reconciling [his] gross habits with [his] net income." I imagine the American public and its representatives are close to their limit of tolerance of the "gross habits" of government and the net new indebtedness they are willing to pass on to their children, all of which suggests that, as an

antidote to what ails the economy, government spending is a thin reed on which to rely. Given the expected slow adjustment rate of the other components of final demand, my guess is it will be a long time before we see growth strong enough and sustained enough to make an appreciable dent in excess capacity. I envision an output path going forward from here that looks something like a check mark, with a near-term snapback from the short, intense downstroke we have experienced, followed by a transition to a long period of slower growth corresponding to the elongated side of the mark.

Mind you, one of my college professors was John Kenneth Galbraith, who warned his students that "the only function of economic forecasting is to make astrology look respectable." My forecast for the economy might be totally wrong. But that is how I see it as a Piscean, and I'm sticking with it.

As to the long-term dangers of inflation posed by the expansion of the Federal Reserve's balance sheet, I remain ever vigilant. I have been outspoken on the reduced need for monetary stimulus in the future. Many of the Fed's special credit facilities have been winding down at a rapid clip as financial markets have begun to function in a more normal manner. And I have been outspoken on the necessity for the Fed to maintain its independence from the Treasury by not increasing its purchases of long-term Treasury securities. As to the Federal Reserve reducing its balance sheet so as not to monetize the excess reserves waiting to be converted to bank loans to the private sector, I have been very clear: Given the lag between the time monetary policy is initiated and when it impacts the economy, that wind-down process needs to begin as soon as there are convincing signs that economic growth is gaining traction and that the lending capacity of the banking system is capable of expansion. Cynics retort that "the Fed may know what to do—but will it have the guts to pull the trigger?" Well, we Texans are not afraid to pull the trigger (as anybody knows who has gone duck hunting with vice presidents of the United States!). I have faith my colleagues on the Federal Open Market Committee will stand and deliver in a timely way.

Recently, a book titled *In Fed We Trust: Ben Bernanke's War on the Great Panic* written by the *Wall Street Journal*'s David Wessel was released. In it, he describes me as one of the "jocks" on the Federal Open Market Committee who is "determined to show [his] manhood by talking tough about inflation and economic rectitude…"[2] He's got that right. I am proud of it. I am paid to be a compulsive worrier preoccupied with price stability and monetary integrity, and I aim to earn my pay.

The Fed does not pay me to promote Dallas and Texas. But I do anyway.

I am grateful beyond belief that Ray Hunt, who was then chairman of the Dallas Fed board, brought me home from eight years in Washington to be president and CEO of the Dallas Fed. I loved being an ambassador; I loved negotiating for my country. But you know what they say. "Washington is 10 square miles, surrounded by reality; Washington is Hollywood for ugly people; Washington is a place where a friend is someone who stabs you in the chest." These are exaggerations. But I do feel blessed to be able to work on national policy at this amazing juncture in economic history with the brilliant staff of the Dallas Fed and live among genuine

[2] *In Fed We Trust: Ben Bernanke's War on the Great Panic*, by David Wessel, New York, N.Y.: Crown Business, 2009, p. 124.

people who are hard headed, pro-business, unafraid of competition, no-nonsense and hardly enamored with the heavy hand of government. They give me the perspective and moral support I need to make the arguments I do at that big mahogany table where the Federal Open Market Committee meets.

It is a great source of pride to me that in 2007, Texas created almost 30 percent of all the private sector jobs in the nation. I delight in the fact that my Federal Reserve District was the only one in the country that created jobs in 2008. Imagine that: While the nation lost over 3 million jobs in 2008 as the peanut butter hit the fan, we managed to create 63,100 jobs in Texas.

It is true that our job-creating machine rolled over in the early fall, and we entered a recession like the rest of the country. And yes, my staff projects that we will have up to 212,000 jobs lost in Texas this year. That hurts: Roughly one of every 50 people in this room has already lost or will lose his or her job this year. My expectation, however, is that the cut is going to be less deep here and require fewer stitches than elsewhere. I expect that we will come out of the recession chute not only quicker but stronger than many other parts of the country.

Why? Because we have the right stuff. If you didn't see it, you should read and re-read the *Economist* magazine's cover article and special section on Texas in the July 11 issue—this little baby right here. It cites many things that are music to my ears. For example, it points out that *Chief Executive* magazine ranks Texas as the best state in which to conduct business. It goes on to say that Texas, and I quote, "has coped well with the recession, with an unemployment rate two points below the national average and one of the lowest rates of housing repossession … [and its] banks … did not overexpand..." (no doubt due to great regulatory oversight by the Dallas Fed!). Texas, it concludes, "offers a different model [than the rest of the states], based on small government … no state capital-gains or income tax, and a business-friendly and immigrant-tolerant attitude."[3]

The magazine is balanced; it also points out our weaknesses—primarily a lack of Tier 1 universities and the potential for a repetition of California's woes as the demography of our state changes. But it makes a clear argument that Texas has the potential to be the crucible of the future of the United States.

This wasn't written by the governor's economic development office. It was written by unbiased parties in one of the most respected journals in the world. I suggest to this chamber that they take this and every piece of propaganda we can garner and immediately put it in the hands of every CEO and leading academic in the country—in Michigan (where Ralph and Comerica moved from) and in California and New York and every other place that has run aground on the shoals of the Great Recession—and proactively go out and incent them to pull up their stakes wherever they are and replant them in this great city and state. We need to strike now and press our comparative advantage to secure the future prosperity of our children and their children and their children after that.

You ought to pursue this mission with the same kind of enthusiasm and vigor you always have in fulfilling your mission here in the North Dallas Chamber. What you have done with this group

[3] "America's Future," *The Economist*, July 11, 2009, p. 13.

and all your other efforts for the greater Dallas area have made and continue to make a huge difference.

I consider chambers of commerce to be the Marine Corps of the economic community of any city.

You remember what Ronald Reagan said about the Marines: “Some people spend an entire lifetime wondering if they have made a difference. The Marines don’t have that problem.” Dallasites don’t have that problem. Texans don’t have that problem. If we can just harness the spirit and devotion that is in this room and spread it city- and statewide, our future will never be in doubt and we will, indeed, inspire the nation.

Thanks for listening. Now, in the best tradition of the Federal Reserve, I’ll do my best to avoid answering your questions.