Recent Decisions of the Federal Open Market Committee: A Bridge to Fiscal Sanity?
(Acknowledging Henry B. Gonzalez and Winston Churchill)

Remarks before the Association for Financial Professionals

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

San Antonio, Texas
November 8, 2010

Recent Decisions of the Federal Open Market Committee: A Bridge to Fiscal Sanity?

(Acknowledging Henry B. Gonzalez and Winston Churchill)

Richard W. Fisher

It hasn't escaped me that you asked me to speak today in the Henry B. Gonzalez Convention Center. Politely stated, Congressman Gonzalez was "wary" of the Federal Reserve. Today, in his memory, I will operate under the presumption that the good congressman, bless his soul, is holding a congressional hearing somewhere in the hereafter and has, as he did here on earth, called upon members of the Federal Open Market Committee (the FOMC) to account for themselves after the Fed's recent actions.

As is our tradition, I can only account for and speak for myself and the Dallas Fed, not for anybody else or any other Bank or for the Federal Reserve's Board of Governors. Today, I will provide a précis of the analysis of the nation's economic predicament I presented to the FOMC last week on behalf of the Dallas Fed, summarize the arguments I made with regard to the course of monetary policy, and then provide a personal perspective on the decision made by the committee as a whole. Afterward, I will do my best to answer any questions you may have.

At all FOMC meetings, after the staff has briefed the committee on projections of the models and provided their own insights, Chairman [Ben] Bernanke calls upon all of the participants in the FOMC discussion to present to the others at the table their individual sense of the economy. When I am called upon, I endeavor to give a perspective derived from the work of the Dallas Fed staff, complemented by the responses to a survey I do personally of a wide swath of CEOs and CFOs of businesses, large and small, across the country as well as financial market operators I know from my former days as a fund manager. There are plenty of sophisticated forecasting models available to all of us at the Fed. To me, the key to crafting monetary policy is placing the theoretical analysis—done by our able staffs of economists using quantitative modeling—within the qualitative context of economic behavior as practiced by businesses, consumers, investors and other players actually operating in the field.

The essence of what I reported to my colleagues when we met last week is that more things are moving in the right direction than in the wrong direction. There are some green shoots beginning to emerge in a landscape still pocked-marked by brown spots. General economic conditions are improving *slightly* and are expected to continue doing so. The risk of a double dip in economic activity has lessened, as has the risk of deflation. Financial speculation and excess, however, is beginning to raise its hoary head.

On the real economy front, data from the manufacturers, railroads, shippers, express shippers, retailers, service-sector operators and others I survey indicate that activity picked up on a year-over-year basis in October and was slightly better than the year-over-year pace of September.

As might be expected, my contacts report price pressures for a range of commodities, including corn, higher-grade food oils, cotton, pulp and, of course, metals and gold used in manufacturing, including specialized products such as semiconductors. This is nothing you wouldn't already

know from a daily reading of the financial press. I do find it of interest that one of my CEO contacts just came back from meeting with all 450 of his Chinese suppliers and reports that the Chinese government was "encouraging" those manufacturers to grant wage increases to their workers on the order of 15 to 20 percent, in large part to goose up domestic spending. Combining wage imperatives with recent commodity price increases, the manufacturers of low-tech Chinese products, from wicker to clothing to the lower end of entertainment devices, have started their bids for supplying the fall of 2011 needs of this particular large importer at dollar price levels 30 percent higher than current levels. Alternative production sites like Vietnam and India, according to this source, are only slightly underbidding these Chinese suppliers.

To be sure, these are opening positions for negotiation. But they are alarming. They might portend a shift back to sourcing low-value-added goods in lower-cost venues like Mexico over time, but in the immediate future, this hints at a squeeze on margins for those sourcing from China, Vietnam and India. Other CEOs who source inputs in the Far East report the same phenomenon, which is vexing because none of them feel they have the pricing wherewithal to pass on cost increases of more than 2 percent or so in light of the weakness of consumption. The one thing they are certain of, however, is that retail goods inflation is highly unlikely to drift downward**.**

This is in keeping with what we see by examining the entrails of the Trimmed Mean PCE calculation of inflation that is done uniquely by the Dallas Fed of the broad basket of items that make up the nation's personal consumption expenditures, or PCE.[1] The Trimmed Mean PCE inflation rate tells a slightly different story from that told by the core PCE analysis, which gets so much attention from most analysts and the FOMC. To be sure, the trimmed mean came in at a 1 percent annualized rate in September, compared with an annualized 1.3 percent rate in August. The numbers for those two months, however, are both above the rates we saw earlier in 2010, and the 12-month trimmed mean rate has been steady over the past six months, within 0.1 percentage points of 1 percent (and clocking in at precisely 1 percent for the past three months).

If the trimmed mean is a better gauge of the underlying trend in PCE inflation (and we at the Dallas Fed think it is), then it's not too surprising that the core PCE rate should be moving down toward the lower and steadier trimmed mean rate. That does not mean we are drifting toward deflation. The message the trimmed mean is sending is consistent with the price picture I have drawn for my colleagues in the past couple of meetings: The underlying trend in inflation appears, for the time being, to be holding steady, albeit at the rate we were accustomed to in the 1950s rather than the rate we have become accustomed to since then.

Without pricing power, and in the face of anemic demand, all of my nonfinancial business contacts—large or small, public or private—continue working to protect their margins through productivity enhancement. And to take advantage of ready access to cheap money to finance productivity enhancement, as well as to refinance their balance sheets, pay dividends or buy in their stock (if they are public). Some of the larger ones report borrowing domestically in size and warehousing those funds so as to avoid having to repatriate the funds building up abroad at onerous tax rates. A few—and this is good news—are using cheap money to refinance their remaining pension obligations in light of unsustainable discount factors used for accounting purposes.

To dwell on a point: Most all the businesses I talk to are expanding investment in productivity enhancement. Far too few of the large companies I talk to report interest in hiring American workers or committing to large-scale CAPEX (capital expenditures) in the United States; they believe their potential for return on investment (ROI) is greater elsewhere. The smaller companies that do not have global options are putting off hiring until the coast is clear on the tax and regulatory fronts. This reticence intensified during the final innings of the election season, which begs the question of whether this will now change with the new Congress. I'll circle back to this issue in my concluding remarks.

Nonfinancial and financial companies alike report that they are flush with liquidity. Bankers are aggressively courting the larger corporate credits; several of my CEO and CFO interlocutors report that in the last few weeks, the biggest banks have approached them "literally begging to lend us 10-year money at less than 3 percent." As you well know, corporate debt markets, including junk markets, are robust. And smaller companies are not complaining about the lack of access to capital. As a special part of our last monthly Texas Manufacturing Outlook Survey, conducted during October, I had our staff ask questions of the 240 companies surveyed about credit availability. Only 60 percent responded that they were seeking credit for financing long-term expenditures, and of that 60 percent, only 18 percent responded that they were having "substantial" or "extreme" difficulty obtaining that financing. Only 54 percent of those 240 Texas companies reported that they were seeking short-term credit, and of that 54 percent, only 12 percent responded that they were having "substantial" or "extreme" difficulty getting credit. To be sure, this survey was specific to my district, the Eleventh Federal Reserve District. But given that the Dallas Fed's Business Activity Index has the highest correlation of all Federal Reserve Bank surveys to sentiment reflected in the national Purchasing Managers Index, or PMI, our survey might have some credence.

It concerns me that liquidity is omnipresent on bank and corporate balance sheets, and yet it is not being used to hire American workers.

It also concerns me that the most recent Lipper/AMG financial market data show year-to-date flows into virtually all asset classes except money market funds. The flows are strong into every category: high-risk to low-risk bond vehicles, taxable and nontaxable, domestic and external, fixed and floating rate, and, of course, commodities. Margin debt remains shy of 2007 highs but is fast approaching levels that prevailed before the NASDAQ implosion in 2001; in fact, margin-account debit balances as a percentage of the market capitalization of the S&P 500 now exceed the precrash level of 1987 and 2001.

Junk yields are at their lowest levels since October 2007. And the leveraged buyout market is back to paying 2006 levels of EBITDA (earnings before interest, taxes, depreciation and amortization) of 6 to 8.5 times, with the recent announcement of Carlyle Group's reported 11 times EBITDA purchase of Syniverse Holdings echoing the peak of the precrash craze. As you know, buyout people do not typically acquire companies with a plan to expand the workforce, but instead with an eye to tighten operations, drive productivity, rejigger balance sheets and provide an attractive payback, usually in shorter time than under normal corporate horizons. And the corporations I talk to that are eyeing possible acquisitions with their surplus cash and ready access to the credit markets are not given to thinking of strategic acquisitions as a way to expand payrolls.

In sum, scanning the business landscape and the conditions of the financial markets, I concluded as a golfer that the greens are playing very fast and must be approached with great caution. At a minimum, I concluded, the committee would need to be very careful in how we calibrated our next strokes, lest we overplay it.

I fully understand the theoretical impulse to drive long-term interest rates to lower levels in hopes of stimulating loan demand and challenging the propensity for economic actors to hoard rather than invest. Given that foreign exchange markets react to interest rate differentials between countries, one effect of engineering lower rates would be to devalue the dollar, presumably to create demand for exports. The ultimate objective would be to advance final demand, generate employment for American workers and revive output.

I agree that we are indeed in what is referred to in economic parlance as a liquidity trap. Yet, I think it worth noting that we already have low interest rates, and spreads against risk-free instruments are historically narrow. Despite their theoretical promise, reductions in interest rates to Lilliputian levels have not done much thus far to spark loan demand. Loans are desirable when business see an opportunity for tapping credit markets to earn a return on investment that significantly outpaces the cost of credit and other risk factors. Even with the low rates that already prevail, businesses lack confidence that they will earn a superior ROI by investing so as to expand their domestic workforce, in comparison to what they might earn from alternative investments abroad or by buying in their stock or cleaning up their balance sheets. For their part, consumers will borrow when they believe it makes sense to shift consumption forward. But after the sobering experience of the past three years, they are restrained by a lack of confidence that their future income streams will be sufficient to cover their payment obligations.

On the supply side, we know that businesses are floating on a sea of liquidity. Banks already hold over $1 trillion in excess reserves; holdings of government securities as a percentage of total assets on bank balance sheets are growing; loans as a percentage of assets are declining.

If we had a level of bank reserves or liquidity in the marketplace that was binding or inhibiting loan growth, I could understand the impulse to relieve that stricture. Further quantitative easing through additional asset purchases will surely increase the level of bank reserves, lower rates marginally and add more liquidity to markets while weakening the dollar. The more germane question is whether this works to the benefit of job creation and wards off financial excess.

In his speech in Jackson Hole, Wyo., in August, Chairman Bernanke had asked all of us to consider the costs and the benefits of further accommodation. My response was that I was skeptical about many of the presumed benefits of further asset purchases. I was more certain of some of the potential costs.

One cost is the risk of being perceived as embarking on the slippery slope of debt monetization. We know that once a central bank is perceived as targeting government debt yields at a time of persistent budget deficits, concern about debt monetization quickly arises.

I realized that two other central banks were engaging in quantitative easing—the Bank of Japan and, most notably, our friends at the Bank of England. But the Bank of England is offsetting an announced fiscal policy tightening that out-Thatchers Thatcher. This is not the case here. Here we suffer from fiscal incontinence and regulatory misfeasance. If this were to change, I might

advocate for accommodation. But that is not yet happening. And I worry that by providing monetary accommodation, we are reducing the odds that fiscal discipline will be brought to bear. More on that in a moment.

I also worry about the risk of our being perceived as using quantitative easing and buying copious amounts of financial assets above and beyond the ordinary bounds of the Federal Reserve's System Open Market Account as "the new normal" for implementing monetary policy. Everything we know from monetary history tells us that in times of crisis, we should open the floodgates—this has been the practice of central bankers since the 19th century. This is what monetary theorists might call Bagehot 101, after the British patron saint of central banking, Walter Bagehot. We did it in 2008 and it worked to pull us from the maw of financial panic and economic ruin. But it did not seem to me last week to be a time of panic or crisis. I suggested that were we to act by throwing more money at the economy under these more benign circumstances, the markets might come to expect more, that quantitative easing could become like kudzu for market operators—expectations of continued Federal Reserve purchases of Treasury securities as normal operating procedure might grow and grow and be terribly difficult to trim once it takes root in the minds of market operators.

I might understand the case for accommodation if serious deflation were a clear and present danger. As I pointed out by citing the trimmed mean and through my anecdotal reports, it is not. I would add for this audience here today that this is thanks to Ben Bernanke's adroit leadership in engineering the liquidity measures implemented during the Panic of 2008-09 and by avoiding the policy errors of the 1930s. Because of what we did in staring down panic and its aftermath, neither M2 money growth nor inflation has fallen off the cliff.[2] And while nominal growth is less than desired and is very painful, nominal income is growing, however incrementally, not shrinking.

I expressed concern about the purported benefits of a weaker dollar in the exchange markets. Much of what we export is in the form of high-value-added goods and services and in commodities like cotton and soybeans that we produce with enormous efficiency. A not insignificant portion of what we import, in addition to oil that feeds into gasoline prices, is used to clothe and support lower-income earners, the very people suffering from unemployment or job insecurity whom we are endeavoring to help. When faced with a further squeeze on their margins that comes with higher import prices, the Wal-Marts, Dollar Generals, Costcos and other stores where the most impacted people buy necessities will likely react by driving productivity even harder, which, translated, means selling more while employing fewer workers.

I also suggested that if the consequence of further easing was to weaken the dollar, this might undermine our standing in international fora, and drawing on my experience as a former Deputy U.S. Trade Representative, might undermine efforts to ward off protectionism.

As to the proposition that higher prices of financial assets will liberate those most in need, I wondered aloud if that were indeed true. We are already seeing the beginnings of speculative activity in stocks, bonds, buyouts and commodity markets. The rich and the quick are certainly able to exploit these circumstances to get richer. I have no problem with market operators making money; I did so myself in my previous life as a funds manager (before I took the vow of financial chastity and joined the Fed!). But I take no comfort, and see considerable risk, in conducting monetary policy that has the consequence of transferring income from the poor and

the worker and the saver to the rich. Senior citizens and others who saved and played by the rules are earning nothing on their savings, while big debtors and too-big-to-fail oligopoly banks benefit from their subsidy. I know of no presidential administration or Congress, Republican or Democrat, that will tolerate, let alone advocate for, that dynamic for long, and I expressed my worry that this could come back to bite us and possibly threaten our independence.

Then there is the issue of exit policy. The more we engage in a policy of asset purchases that moves us further out the yield curve—and the more we laden our balance sheet with price-sensitive assets—the greater the likelihood of realizing a loss on our holdings. One can model out some of this risk and conclude that the coupon stream of the securities we will be holding will protect us against capital loss under reasonable price-reversal scenarios. But if unreasonable scenarios prevail, I shudder at the prospect of the Chairman or any other members of the FOMC appearing before the House Banking Committee in 2012 to report that the central bank of the United States has generated a loss of X billion dollars.

In sum, I asked that the FOMC consider that we might be prescribing the wrong medicine for the ailment from which our economy is suffering. Liquidity and abundant money are not the binding constraints on the economic activity we wish to see. The binding constraints are uncertainty about income and future aggregate demand, the disincentives fiscal and regulatory policy impose on ridding decisionmakers of that uncertainty, and the reluctance, given those disincentives, of those who have the power to create jobs for our people to invest in undertakings that would create them.

The remedy for what ails the economy is, in my view, in the hands of the fiscal and regulatory authorities, not the Fed. I could not state with conviction that purchasing another several hundred billion dollars of Treasuries—on top of the amount we were already committed to buy in order to compensate for the run-off in our $1.25 trillion portfolio of mortgage-backed securities—would lead to job creation and final-demand-spurring behavior. But I could envision such action would lead to a declining dollar, encourage further speculation, provoke commodity hoarding, accelerate the transfer of wealth from the deliberate saver and the unfortunate, and possibly place at risk the stature and independence of the Fed.

My perspective, as with those of all other members of the FOMC, was given a thoughtful and fair hearing at the table. After deliberation, the majority of the committee concluded that under current and foreseeable conditions, the better approach was to purchase $600 billion in Treasuries between now and the end of the second quarter of next year, on top of the amount projected to replace the paydown in mortgage backed-securities. The math of this new exercise is readily transparent: The Federal Reserve will buy $110 billion a month in Treasuries, an amount that, annualized, represents the projected deficit of the federal government for next year. For the next eight months, the nation's central bank will be monetizing the federal debt.

This is risky business. We know that history is littered with the economic carcasses of nations that incorporated this as a regular central bank practice. So how can the decision made last Wednesday be justified?

Chairman Bernanke provided a public answer in an editorial in the *Washington Post* the day after the meeting. In that editorial, he summarized the analysis of the majority of the committee:

"This approach eased financial conditions in the past and, so far, looks to be effective again. … Easier financial conditions will promote economic growth … lower mortgage rates will make housing more affordable and allow home owners to refinance. Lower corporate bond rates will encourage investment. And higher stock prices will boost consumer wealth and help increase confidence, which can also spur spending."

For good measure, he added, "We have made all necessary preparations, and we are confident that we have the tools to unwind these policies at the appropriate time." And over this weekend, he added in a public speech that he did not think the new levels of asset purchases would unleash "super ordinary" inflation.

Having made my arguments to the contrary, I am a member of the committee that Chairman Bernanke leads. I respect the will of the committee and defer to the Chairman as its spokesperson.

I would suggest that even if you share my cautious perspective on this matter, you might be assuaged by looking at this new initiative as a bridge loan to fiscal sanity. We have a new Congress. From my perspective, there are two ways your central bank can approach them: the way it is being done by the Bank of England, which appears to me to be seeking to cushion the adjustment to a policy of fiscal abstinence by a new government after a prolonged period of fiscal debauchery; or to provide the space necessary for our newly elected Congress to work with the president to find a way to restore fiscal sobriety without choking off economic recovery.

The new leadership of the House of Representatives, and the reelected leadership of the reshaped Senate, together with President Obama, surely must understand that we are at the end of the line and that time is of the essence. The Fed is doing its level best to deliver on the dual mandate it was given by the Congress. But monetary accommodation, by itself, is not the answer to our current woes. The Fed, as I see it, has taken a leap of faith that our political leaders will forge a sensible budgetary and regulatory path that incentivizes businesses to put to work the money the Fed is printing to invest in creating jobs for American workers while averting what the Stanford historian David Kennedy described in yesterday's *New York Times* as "a looming fiscal apocalypse." We need for the Congress to move quickly, beginning in its lame-duck session. As Winston Churchill said, "We need action this day!"

Otherwise, the effect of quantitative easing will, in my view, simply result in financial speculation, further investment in more welcoming quarters abroad and, ultimately, in "super ordinary" inflation. The FOMC is taking a calculated risk. If the Congress and the Executive fail to deliver, I believe the FOMC will have to consider changing course.

Here is the message: The Fed is going out of its way to be a good citizen. It is time for the Congress to do the same.

Thank you.

Notes

[1] The Trimmed Mean PCE inflation rate is an alternate measure of core inflation that strips items that have had large price movements in a given month.

[2] Components of M2 are savings accounts, small CDs, money market mutual funds, currency and checking accounts.