

Texas: What Makes Us Exceptional? Where Are We Vulnerable?

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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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I am honored to speak to the new members of the Texas Legislature. I am especially grateful to the speaker for inviting me here today.

I am a little surprised you would ask an official of the Federal Reserve to deliver your keynote address. We are not the most fun people to have around. You know the story: After a worrisome physical, the doctor at M.D. Anderson turns to his patient. “The results are not good,” he says. “I suggest you marry a Federal Reserve official and move to Maypearl over there in Ellis County.” “Geez,” the patient says. “Will I live longer if I do?” “No,” the doctor replies, “but it will sure feel that way.” (I thought Rep. Jim Pitts would like that one.)

Speaker [Joe] Straus, I’ll do my best to set aside my stodgy Federal Reserve mannerisms today and try to make it snappy.

First, some background on the Fed, so you’ll understand where I am coming from. At each of your places is a crisp new Federal Reserve note, a dollar bill. (For the record, I paid for these out of my own pocket; I may be the first speaker to come before this august body and pay you to listen!) You will see that this bill has the letter *K* printed on its face and four 11’s printed near each corner. The Dallas Fed is the 11th Federal Reserve District out of 12 operating across the country. *K* is the 11th letter in the alphabet. There are two concentric circles around this letter *K*. The outermost says “Federal Reserve Texas.” The innermost concentric circle says “Bank of Dallas.” I like to chide my colleagues that not all dollar bills are equal. I tell them those with the letter *K* on them—what I call “Texas dollars”—are worth more than all the rest because they represent the nation’s most dynamic economic machine.

The 12 Federal Reserve Banks were set up by federal law in 1913. I am president and CEO of the Federal Reserve Bank of Dallas, which, together with our branches in Houston, San Antonio and El Paso, handles the business of the Fed in this part of the country, ordering and distributing paper money according to the needs of our district, supervising and regulating banks, lending money against good collateral to all banks in our district for their operating needs, whether we supervise them or not, handling payments (for a fee) for the U.S. Treasury, doing economic studies, educating the public on basic financial matters and helping determine the nation’s monetary policy at meetings of the Federal Open Market Committee (FOMC).

At the FOMC table, I represent the perspectives of some 27 million people who reside in the approximately 360,000 square miles of land that stretches from northern Louisiana to southern New Mexico and produces an economic output that is greater than that of Mexico or Australia and, until recently, exceeded that of India.

The Dallas Fed makes a profit through its lending and other fee-generating activities: We receive no tax appropriations. After paying a small preferred dividend to the member banks of our district, we turn over our annual profit to the U.S. Treasury. Last year, the 12 Federal Reserve banks collectively turned over \$47 billion to U.S. taxpayers. You are looking at an odd duck: A member of a team within a government agency that doesn’t swallow taxpayer money but,

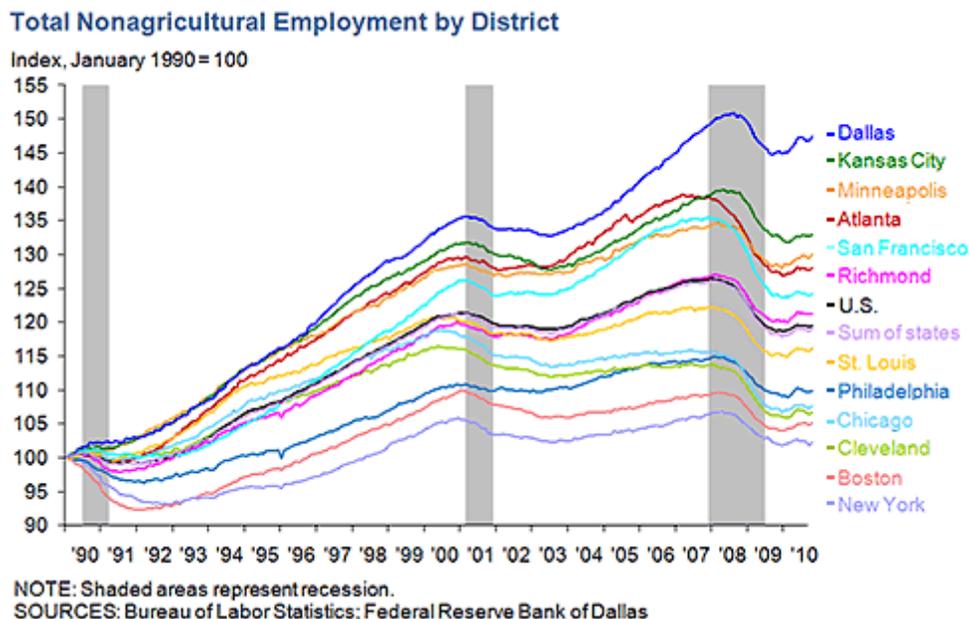
instead, operates with private sector efficiency and uses its profits to directly pay down the nation's debt.

Another thing that makes me an odd duck: I am not accountable to any political authority. Unlike the seven members of the Federal Reserve Board, neither I nor my counterparts who operate the Fed's business through the 12 Reserve Banks are appointed by the president of the United States or confirmed by the U.S. Senate. I was selected for this job by—and serve at the pleasure of—the nine directors who compose the Dallas Federal Reserve Bank board, all of whom are citizens of the Fed's Eleventh District. That board, which was chaired by Ray Hunt when I was hired, has been chaired for the past three years by Jim Hackett, the CEO of Anadarko Petroleum, and will, in turn, be chaired starting in January by Herb Kelleher, the founder of Southwest Airlines. The board consists of eight other individuals who presently hail from Dallas, Houston, Plano, Brady, Huntsville, Fort Worth and Alamogordo, N.M. The Dallas Fed is a Main Street operation.

When I was sworn into office, I checked all politics and partisanship at the door. I am neither an "R" nor a "D"; I am politically indifferent. When I took this job, Alan Greenspan told me I had only one obligation, which in his words was "to speak to the truth." I do my best to speak the straight skinny, informed by the work of the staff of the Dallas Fed, the input I receive from the bankers and businesses and citizens of my district, and my own career as a banker, an investor, a trade negotiator and a man smart enough to come to Texas 37 years ago.

So what is the straight skinny about the Texas economy?

Over the past 20 years, our employment force has grown at an annual rate of about 2 percent and our economic output has expanded 3.4 percent. At your seat, attached to your Texas dollar, is what we call a "spaghetti graph"—it charts the employment growth over the years of the Eleventh District economy, the bulk of which is Texas, relative to other Fed districts. This graph says it all: With each passing year, we have consistently outperformed the rest of the nation in growing economic prosperity.



Over the past three especially difficult years, the Texas economy has outperformed all other states, except for those tiny ones whose populations would not aggregate to the size of any of our major cities. Texas was last into the recent frightful recession and one of the strongest coming out. In 2008, we were still creating jobs here. In fact, while the U.S. lost 3.1 million jobs, Texas added 45,000 private sector jobs in 2008. But stout as we are, we caught the recessionary flu at the onset of the fall of 2008, with the result that we lost 362,000 jobs in 2009. We recovered quickly and at a faster pace than the rest of the nation. So far this year we have regained 158,000 jobs and grown at an annual pace of 1.9 percent—a little more than twice the national average of 0.8 percent.¹

As of October, the Texas unemployment rate stood at 8.1 percent. To be sure, this is much lower than the national average of 9.6 percent. While our recovery has outpaced that of the nation thus far, unemployment remains stubbornly high and too many Texans are out of work. A big part of your job here in Austin as new legislators is to create the incentives for business to invest and create jobs here and drive that rate of unemployment down.²

I expect that during the Q&A, you'll ask me for a forecast for Texas' economic growth going forward. Let me head that off at the pass. I am wary of precise economic forecasts. Economics is an art form more than a science, despite claims to the contrary. As such, economic prognostications need to be taken with a grain of salt, even when delivered by Federal Reserve officials, for they are seldom accurate and are subject to constant revisions. One of my professors in college used to say that "the only function of economic forecasting is to make astrology look respectable." So let me just say—as a Piscean—that our Texas economy continues to face significant headwinds, including uncertainty that derives from the indecision or sometimes counterproductive decisions of the national government. And we will continue to be handicapped by low levels of construction activity—particularly commercial construction—largely due to reduced state and local government spending and still moderate gains in consumer spending and demand. Despite these conditions, I expect Texas job growth in 2011 to continue to increase, but only if you can preserve the image and reality of Texas' uniqueness as a place to do business and grow profits. Profit-making enterprises create jobs. We have too many unemployed workers. We need to attract businesses to come here and grow here. To do so, we have to press our comparative advantage relative to other states.

So what is our comparative advantage?

As I see it, the key to Texas' success lies in our ability to change to a rapidly globalized and competitive economic landscape. Texas' transition from a resource-based economy built on cattle, cotton and oil to a knowledge-based economy built on human capital and innovation is our greatest success. We have made a fine transition "from cow chips to computer chips" and "from boots to suits." Texas has mastered the art of what the iconic economist, Joseph Schumpeter, called "creative destruction." We don't linger long on the old, and we are quick to usher in the new.

In the 1930 census, for example, agriculture represented 39 percent of all jobs in the state; today, it is less than 1 percent. Despite this decrease, we continue to be one of the top agricultural producing states in the nation. We are currently No. 1 in ranching and No. 2 in terms of crop production.

In 1970, 15 percent of Texas jobs were in manufacturing. Presently, manufacturing accounts for only 7 percent of our employment, though output in manufacturing has fallen much less, from 18 percent to 15 percent. Both of these sectors saw a decline in job share not due to the demise of industry, but rather because productivity growth has allowed technology to do more of the work. This has allowed labor to shift to other areas of the economy that are in high demand as our population has become wealthier, including health care, education, finance and leisure services.

A key source of Texas' growth in manufacturing and services has been technology. The most recent Milken Institute study on high-tech centers across the U.S. concludes that Texas has three of the top 25 high-tech centers in the country—Dallas, Houston and Austin.³

The key factors that have contributed to our ability to grow and adapt to the changing landscape are low tax and regulatory burdens, flexible labor markets, open land availability, the success of tort reform, great seaports, airports and transportation and communication infrastructure, and simply put, the fact that people come here to work and better themselves. All these factors have contributed to a low cost of living and have made doing business in Texas much easier.

Businesses sell to national and international markets and must compete with producers throughout the world. As a result, they seek areas of production where nominal wages are low for a given level of worker productivity. What matters to workers, however, is their real wages—what they can buy for an honest day's work. A worker can move from the Silicon Valley or Boston to Dallas or Austin (or Fort Worth or Houston or San Antonio or El Paso), and both the company and the worker are better off. The company can pay him, say, 15 percent less, and yet the worker, who spends a significantly smaller amount for the same home he had in Silicon Valley or Boston, is taxed at lower rates, finds the cost of living cheaper and sees his real income increase by a significant amount. This is what I call the "pull factor," and it has been a key component of the net immigration of workers and job-creating businesses to the state of Texas.

Data from the Real Estate Center at Texas A&M University show that net domestic immigration to Texas has been positive every year for at least the past 18 years. In just the past five years, net migration from other U.S. states (not including international migration) has totaled about 690,000 individuals—equivalent to about 40 percent of the population of the Austin–Round Rock MSA. Positive net migration from other states is a key indicator that we are, in fact, exceptional. People do vote with their feet. They are moving to Texas from other states and from abroad because we offer them something better than they have at home.

This has not gone unnoticed. Just this week, a report published by the Brookings Institution in Washington ranked Austin as the No. 1 city in the U.S. and No. 26 in the world in terms of jobs and income growth during the current economic recovery.⁴ Their explanation for Austin's, and Texas', success—"continued attraction and retention of high-skilled human capital, its diverse set of export-based industries, and its avoidance of the worst U.S. housing market excesses." This same study ranked Dallas fourth in the U.S. and 39th in the world in terms of the strength of the recovery. San Antonio ranked 11th and 51st, respectively, while Houston ranked 15th and 61st. As to how others held up during the recession itself, Brookings cited San Antonio as the most "recession-proof" city in the United States.

There is a lot of room for Texas brag when we talk about our economy and our potential. But we also have vulnerabilities that keep Texas from reaching its full potential. In the latest rankings on the competitiveness of states, the Beacon Hill Institute gave mixed results to Texas. The “good news,” according to the institute, is that Texas scores high on overall tax burden, employment in high-tech industries, venture capital, IPOs, low unionization, unrestrictive minimum wages, exports, foreign direct investment and percent of population born abroad who come to work. The bad news: Texas was ranked near the bottom in most human capital measures. Texas is ranked dead last in the percent of the adult population that graduated from high school, 37th in percent of population enrolled in degree-granting institutions, 35th in academic R&D and 41st in science and engineering degrees awarded.⁵

When you get a chance, take a look at the membership list for the Association of American Universities (AAU), which is regarded by most scholars as the definition of the cream of the crop of research universities. The AAU consists of 61 U.S. and two Canadian universities. These 61 U.S. schools garner about 58 percent of all federal R&D dollars to colleges and universities; they are home to 82 percent of all elected members of the National Academy of Sciences, the National Academy of Engineering and the Institute of Medicine—the highest recognition in each of those fields. Since 1901, 35 percent of all Nobel Prizes have gone to individuals affiliated with AAU universities.⁶

California has nine AAU members. The New York area also has nine. And Texas? We have three: Rice, UT–Austin and Texas A&M.

Another source that underscores the Achilles heel of Texas’ economy is *U.S. News and World Report*. According to its ranking system, Massachusetts has 10 ranked in the top 100 universities—what might be referred to as Tier One universities. The New York area has 11 and California has 14. We have only six: Rice, which is ranked 17th, UT–Austin (ranked 45th), SMU (ranked 56th), Texas A&M (ranked 63rd), Baylor (ranked 79th) and TCU (ranked 99th).⁷ I admire the Rice Owls, but I am embarrassed by having them as the sole university in the nation’s top 20. You should be, too. We ought to have several.

You can’t be happy with the fact that we are falling behind in all aspects of education, from kindergarten right up to the university level. Think about it. We know that incomes and net worth are directly correlated to educational attainment. We know that in the Knowledge Age in which we live, the mind is the capital plant of the modern economy. We all admire those who work with their muscles and by the sweat of their brow in pulling prosperity from the soil on our farms and ranches, or from deep beneath the earth in our mighty oil and gas sector. We rightly applaud those who help Texas produce almost 10 percent of the nation’s manufactured goods. But the world of today and tomorrow is driven by digits, not widgets. We will continue to move up the value-added ladder and stay ahead of the competition—not just from other states, but from China and the new emerging powers—only if we are able to nurture and harness Texas brains.

You have a lot on your plate as new legislators. Don’t lose track of this simple, unalterable, indisputable, critical fact: We have done well so far; our economy is mighty. But to stay ahead of the curve and compete in tomorrow’s global marketplace, Texas must do better in educating its population.

An obvious challenge for all of you is going to be dealing with the biennial budget at a time when our communities and our nation are fiscally strained. Over the past two years, Texas stood out because it appeared to encounter only modest fiscal imbalance after entering the recession later than most other states. Yet now there is talk that a two-year budget deficit of some \$21 billion is looming.

We will see what [Comptroller] Susan Combs releases in January regarding the official predicted shortfall. Whatever that number is, one thing is certain: Plugging a deficit isn't going to be painless. Sales tax accounts for about 65 percent of our state's tax revenue; while its freefall has abated and is reversing, sales tax is unlikely to grow as dramatically over the biennium as we would like. On the other side of the ledger, education accounts for 41 percent of state expenditures. It is not my job to tell you how this issue should be resolved—the Fed creates money, but you and your counterparts in Washington are the folks elected to decide how much of it is collected from the people in the form of taxes and then parsed out. My job is to remind you that if you wish for Texas to remain a beacon of entrepreneurialism and capitalist hope in today's knowledge-based economy, the current budget dilemma must be resolved. And if you want Austin and all of Texas, in the words of that Brookings Institution report, to continue to “attract and retain high-skilled human capital,” it must not be resolved by cutting off your noses to spite your face by shortchanging education.

This is not to say that education quality is determined solely by the number of dollars we direct to it. To be sure, there are many nonfiscal aspects of our unexceptional and vulnerable education system that need to be addressed. My plea is that each of you make it one of your principal goals to make Texas an educational powerhouse. High-value-added, job-creating businesses that are world beaters will not move their top executives to Texas unless they can send their children and grandchildren to top schools and universities.

Whatever our ethnicity or origin, Texans are a race of risk takers. We have from the very start defied conventional wisdom. We must now take risks, defy conventional wisdom and turn around our education system. Our economic future depends upon it.

If you're looking for motivation to do what most others consider unthinkable, dust off T.R. Fehrenbach's history of Texas, titled *Lone Star*. It's a long book—some 719 pages. But it is most readable and is, to my mind, perhaps the finest history of Texas ever written, though it has now been over 40 years since it was first printed.

For example, Fehrenbach walks his readers through how Mirabeau B. Lamar moved the capital to Austin in 1840.⁸ Then, only 900 people lived here on the border of Comanche country, facing a wild, frightful, untamed western frontier. Yet here we are today, as I mentioned, with one of the most elite think tanks in the country concluding that Austin is the highest ranked of all American cities in this recovery and ranked internationally, incidentally, just below São Paulo and above Montreal. Little old Austin, ranked right up there with two of the best-known cities in the world. Who would have thought that possible?

Who would have dared think that in the blink of history's eye, Texas would be outproducing Mexico or Australia and give the more than 1 billion people of India a run for their money? Fehrenbach recites how great men and establishment figures of the time like John Quincy Adams

scoffed at Houston and Lamar and at Texas. Too bad they aren't around now to see what those early Texas legislators and their successors—your predecessors—set in train.

What has been accomplished here could only have been made possible by a Texas government that understands that it pays to respect the “animal spirits” that drive entrepreneurialism and risk taking that pushes the economic frontier both literally and figuratively. A legislature that dreams big. How else can you explain the chutzpah of the Texas Congress that once passed a resolution declaring the Californias as Texas soil? Or the gall to negotiate diplomatic recognition or commercial treaties with Britain and France, Belgium and the Netherlands. Or commission its own sovereign Navy and become so vexing a force that Texas' annexation became the cutting edge issue that helped determine the election of the dark-horse candidate, James Polk, as president of the United States, with whom your predecessors then negotiated the only deal with the United States allowing a state joining the union to retain title to all of its unoccupied land rather than surrender it to Washington?

As Fehrenbach puts it: “The Texan ethic and Texas society rewarded enterprise,”⁹ ... “work was the real virtue.”¹⁰ “We chose this land; we took it; we made it bear fruit.”¹¹ We are a people for whom “the cult of courage was obvious.”¹² And it is still obvious, whether you live in Brady or Huntsville or the toniest neighborhoods of Highland Park, Alamo Heights or River Oaks. Or even Maypearl.

Fehrenbach distills the Texas spirit into one simple sentence: “Men who exist get overrun by men who act.”¹³

Now, if you were from part of the United States where the past is more glorious than the future and you were listening to what I have said today, you would at this point of this speech likely be thinking this all sounds like something that rhymes with “bull wit.” But we who live here know this place and its spirit.

My wife, Nancy, and I so love this place that we named our youngest child Texana. She was a pistol—blond and tall and beautiful. She was a published poet, an accomplished artist, and a brilliant student at Wellesley College and at Harvard. She spoke fluent German, Italian, Russian and Spanish. Yet she was a Texas woman: She could outfish and outride any man and was happiest when she was in the wide-open outdoors of our ranch in East Texas. She was taken from us in April. She was 24.

I make this plea of you today in Texana's memory: You and your colleagues in the Texas legislature are the trustees of the future of her generation and all that come after her. You hold the future of this unique franchise we call Texas in your hands. Your job is to keep Texas exceptional—to create the conditions that safeguard and nourish our prosperity and that of our children and our children's children. You've got some tough decisions to make. Be courageous. You are not here “to exist.” You are here to act.

¹ The Dallas Fed data are slightly different from the Bureau of Labor Statistics data. The BLS updates its data once a year to take into account better information. Instead we roll in this better information every quarter as it becomes available. This leads our data to be more accurate and less subject to big annual revisions.

² What explains our outperforming the nation since 2007? Much of the answer lies in the importance of the energy and high-tech sectors to the Texas economy. These industries play a greater role in the Texas economy than in most states, and subsequently, play a large role in our relative fortunes.

Importantly, however, the Texas economy was not hit as hard by the housing crisis. Some of this is due to the fact that, in response to our housing crisis of the late 1980s and early '90s, Texas policymakers instituted more stringent rules on home equity lending. Due to land availability and unrestrictive development regulations, we can also add to the housing stock without sharp increases in housing prices. Without the big price gains that characterized housing markets in other states, the Texas housing market was less vulnerable to the lax lending standards that grew rapidly around the country. If home prices are increasing 20 percent a year, it is easy to hide the issues caused by little to no down payments, few documents and so-called balloon payments: As long as the housing tree grows to the sky, a home owner who can't make payments simply sells the house and earns a capital gain. But this is a fool's errand. When home prices begin to fall, homeowners who find they can no longer make their mortgage payments are unable to sell, and foreclosures rise sharply, driving prices down further. It is a vicious cycle that is still playing itself out around the nation—but not so painfully in Texas, where prices were growing much more slowly and the types of loans to homeowners that have proven so toxic elsewhere were not as prevalent.

The loss in wealth associated with the fall in home prices has damped consumer spending, which has traditionally made up about 70 percent of our state's and our nation's economy. Currently consumers both in Texas and the U.S. are paying down both consumer and mortgage debt. This deleveraging will continue to slow consumer spending through much of next year. The good news is that Texas consumers did not increase their debt burdens as much as consumers in other areas of the country and have less debt relative to income to pay down. In short, the absence of a boom and bust in housing prices in Texas has been a stabilizing force in our economy.

Another buoying factor has been Texas' exports, which play an important role in the Texas economy. According to the Origin of Movement series produced by the Census Bureau, Texas is the No. 1 state in terms of the value of exports shipped: We surpassed California nine years ago. The rebound in exports over the past year has been a key factor driving the rebound in Texas manufacturing. Exports, as a matter of fact, are one of the few economic indicators that have reached prerecession highs. This is to be expected given the quick rebound in many emerging market economies. Our largest export industries are computers and electronics (20 percent of exports), chemicals (18 percent), petroleum and coal products (16 percent), machinery (13 percent) and transportation equipment (10 percent). The regions we export the most to are Mexico (35 percent), Asia excluding China (17 percent), Latin America excluding Mexico (16 percent), the European Union (11 percent) and Canada (10 percent).

The fastest growth in exports has occurred with China—exports to China from Texas ports have increased by over eightfold since the late 1990s. So far in the first three quarters of this year, the strongest exports from Texas have been petroleum and coal products and computers and electronics, although almost all industries have shown solid gains. The region with the strongest growth overall has been Latin America. I mention this because so many politicians on the right and left elsewhere in the nation are talking more and more about trade restriction. Don't fall for it: Protectionism is the crack cocaine of economics. It gives a temporary political high but is addictive, is economically debilitating and, eventually, proves fatal for an export powerhouse like Texas.

³ See "North America's High-Tech Economy: The Geography of Knowledge-Based Industries," Milken Institute, June 2009, www.milkeninstitute.org/publications/publications.taf?cat=resrep&function=detail&ID=38801199.

⁴ See "Global Metro Monitor: The Path to Economic Recovery," Metropolitan Policy Program, Brookings Institution, December 2010, www.brookings.edu/reports/2010/1130_global_metro_monitor.aspx.

⁵ See "State Competitiveness Report," Beacon Hill Institute for Public Policy Research, Suffolk University, 2010, www.beaconhill.org/Compete10/Compete2010State.pdf.

⁶ See Association of American Universities website at www.aau.edu/about/default.aspx?id=4020.

⁷ See National Universities Rankings, *U.S. News and World Report*, <http://colleges.usnews.rankingsandreviews.com/best-colleges/national-universities-rankings/>.

⁸ *Lone Star: A History of Texas and the Texans*, by T.R. Fehrenbach, New York: Macmillan Publishing Co., 1985, chapter 15.

⁹ *Ibid.*, p. 708.

¹⁰ *Ibid.*, p. 709.

¹¹ *Ibid.*, p. 712.

¹² *Ibid.*, p. 712.

¹³ *Ibid.*, p. 717.