

A Perspective on the U.S. Economy and Monetary Policy

*(With Reference to the Music of Richard Wagner and
Gangsta Rap)*

*Remarks before New Mexico State University's
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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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Thank you, President [Barbara] Couture, for that kind introduction. It is an honor to speak at New Mexico State University.

I will keep my comments as brief as possible this afternoon so as to leave ample time for Q&A. I want to first provide the précis of the analysis of the nation's economy that I presented to the FOMC (Federal Open Market Committee) last week on behalf of the 27 million citizens of the 11th District of the Federal Reserve System, including the citizens of Las Cruces and southern New Mexico. Second, I will discuss inflation as we see it at the Dallas Fed. But before getting into these weighty matters, let me demystify the Federal Reserve System and the Dallas Fed's role within that System.

If you look closely at the face of any one dollar note, you will see a letter in the middle of the left side. Every one dollar bill bears the imprint of one of the Federal Reserve Banks, starting with the "A" of the Boston Fed and ending with the "L" of the San Francisco. Dallas Fed dollars are identified by the letter "K," surrounded by two concentric circles. The outer circle says "Federal Reserve" and "Texas," and the inner circle says "Bank of" and "Dallas." "K" is the 11th letter in the alphabet—in all four corners of the bill are printed the number "11." The Federal Reserve Bank of Dallas is responsible for the administration of the Federal Reserve's affairs in the 11th of 12 Federal Reserve Districts that were set up by Congress under the Federal Reserve Act of 1913. Presently, there are nearly \$1 trillion worth (\$903 billion to be exact) of Federal Reserve notes in circulation. (Of course, you know that Dallas Fed dollars are of greater nominal value than the others!)

The economic activity conducted within the Eleventh District—which includes roughly 27 million people and covers some 360,000 square miles in southern New Mexico, Texas and the wooded north of Louisiana—is serviced by the Federal Reserve Bank of Dallas and its three branches.

I am the president and CEO of a \$98 billion bank. That bank operates at a profit—a profit that we send to the Treasury. Indeed, the 12 Federal Reserve Banks, collectively, transferred approximately \$79 billion to the Treasury in 2010. You are looking at an individual affiliated with one of the few public agencies that actually pay down the federal deficit.

What do we do for those 27 million people in the Eleventh District? For starters, we make sure they have the cash they need. In the first quarter of this year, the Dallas Fed distributed and received almost 1.5 billion circulating banknotes, worth nearly \$27 billion at face value. Our mammoth machines scan the cash at an average rate around 100,000 bills per hour and process them so they can be shipped from our vaults in El Paso, Houston and Dallas to banks throughout our district, providing you and the other citizens in our district with folding money. Of course, in addition to making sure there is a sufficient amount in circulation, we have to make sure your folding money is valid and looks respectable: Each month, we cull hundreds of counterfeit bills, and we pluck out about 36 million worn bills that have lived a full life and are ready to be shredded, sent off to money heaven and replaced by new, crisp notes.

Beginning this year, the Dallas Fed no longer processes checks. (In 2009, we processed 120 million paper checks.) Since the use of paper checks has been, and will continue to be, on a substantial decline as consumers and businesses take up electronic counterparts, the Federal Reserve Board decided to consolidate all paper-check processing with the Federal Reserve Bank of Cleveland. (After the loss of LeBron James, losing paper-check processing would have been too much for the city to handle.). The Federal Reserve Bank of Atlanta will serve as the sole electronic-check processing site for the entire System.

Another important function of the Dallas Fed is to provide liquidity to district depository institutions through our discount window operations—in other words, to be the ultimate banker’s bank. Those of you in this room who are at all affiliated with depository institutions are certainly aware of this vital function. The lending programs that make up our discount window help relieve liquidity strains by providing a source of short-term funding, which is fully secured and collateralized, to depository institutions to help them conduct uninterrupted business on behalf of you and their other customers. In 2009, we made 594 loans approximating \$30 billion, and in 2010, we made 156 loans for about \$3 billion. I chair our credit committee and personally review the loans we make every evening. Their size and structure depend on the needs of the borrowing bank.

Among our other responsibilities is supervising the banking industry within our district. We conduct on-site audits of our state-chartered member banks and bank holding companies and monitor bank performance and stability using electronic surveillance technologies. Currently, we supervise 37 “state member” banks and 522 bank holding companies, ranging from more than \$50 billion to less than \$20 million in total assets. In June of this year—thanks to the Dodd–Frank bill—we will take on the responsibility of supervising savings and loan holding companies. We currently have 92 of them in our district.

This supervisory role is important. I began my private-sector career at the bank of Brown Brothers Harriman & Co., where my superiors instilled in me one overarching principle—one I’m sure the bankers in this room know quite well: Know your customer. Well, we at the Fed rely upon our regulatory relationship to better know our customers, actively monitoring our constituents’ needs and services on the front line of the commercial banking industry and using this insight to be better lenders to all our customers. Without that supervisory and regulatory responsibility, we could not operate effectively as the nation’s lender of last resort. Moreover, the knowledge gained through banking supervision aids the formation of monetary policy.

The Dallas Fed also organizes public education programs designed to raise financial and economic literacy in our community. We frequently host public events and conferences on significant activities within our economy. Not unimportantly, we work with universities and high schools throughout our district. Our team at our El Paso Branch, for example, works with students in New Mexico State University’s Doctor of Economic Development Program, which allows students to participate in internships at the branch. We have partnered with New Mexico State University to sponsor the Collegiate Advisory Board—an independent study program—and we have developed a Student Board of Directors program for the top high school students for the Las Cruces school district.

Currency processing, banking supervision, lending as a banker's bank and public education efforts are integral parts of the Federal Reserve's job. But you wouldn't know it if you read the papers: They are not the parts of central banking that usually garner the most public attention. The sexier bits of what I do—to the extent anything in central banking is considered “sexy”—deal with monetary policy.

The presidents of the 12 Fed Banks, in addition to the five governors of the Federal Reserve Board (two shy of normal, thanks to a holdup in the nomination and confirmation process), normally meet every six weeks to discuss the current trajectory of the economy and craft the appropriate policy response. We do so in a meeting of the Federal Open Market Committee, commonly known as the FOMC. It is in these meetings that we set the base interest rate for interbank lending known as the federal funds, or “fed funds,” rate and where we develop other monetary policy initiatives, like the various programs we put in place to restore liquidity in the commercial paper and mortgage and other markets during the recent financial crisis.

I come to each FOMC meeting armed with input from a research team that provides the intellectual heft for informed monetary policy making, as well as insights provided by board members, including Laura [Conniff] and Cindy [Ramos-Davidson], and the many businesses—large and small—that populate my district and with whom I constantly consult. The Dallas Fed employs a crack team of economists and analysts who study the local, national and international economies. Their work is top-notch. Few of you might know, for example, that Finn Kydland, an advisor to our research team in Dallas for the past 15 years, won the Nobel Prize in economics in 2004.

The FOMC is one of the few public service decisionmaking bodies in the world where members can come together and, in the span of only a few hours, present their positions without fear of political retribution and without posturing for the cameras, then hammer out agreement on a course of action based solely on what they solemnly consider judicious for the long-term health of the economy rather than for political convenience. On the afternoon in which we conclude our discussion, we craft a statement for public release explaining the actions taken. We release a lengthy set of minutes of our deliberations three weeks after our meeting.

The FOMC is where Texas and the parts of Louisiana and New Mexico that we cover have a voice at the policymaking table for the most powerful and essential central bank in the world. The president of the United States appoints and the Senate confirms the governors of the Federal Reserve System. The 12 Federal Reserve bankers like me who sit side by side with those governors are not subject to that process. We are hired and fired by nine-member boards of directors that represent the financial institutions and stakeholders and economic diversity of our respective districts. I want to make this clear: I am not accountable to any Washington politicians, be they Democrat or Republican. I am politically neutered, devoutly nonpartisan and guided solely by what I believe is the best way to craft policy so as to encourage sustainable economic growth with price stability, regardless of who is in the White House or the Congress. I work hard to represent the views and ideals of my part of the country. My fellow Bank presidents and I represent Main Street, not the Washington or Wall Street establishment. I want you to know that every time I speak or intervene in our policy discussion at the FOMC—which is quite often (I am, after all, a Texan)—I do so very much with that in mind.

Economic Overview

Which brings me to our current economic situation.

Despite being hit with a variety of shocks last year and early this year, the economy continues to recover. Last year, concerns over the euro debt crisis and uncertainty over health and financial reform slowed the economy's momentum during the summer. But the economy shook off those drags and reaccelerated late last year, reflecting a combination of policy stimulus and the ability of the U.S. economy to reinvigorate itself. More recently, bad winter weather and an increase in energy prices have sapped some steam from the recovery this year. Nevertheless, a host of more timely indicators suggest that economic growth will likely pick up in coming months.

The recovery in manufacturing and a bounceback in capital goods orders are particularly heartening. Not only do they contribute toward an economic recovery, but they are also harbingers of a needed rebalancing of our economy. During the credit boom of the prior decade, we became too dependent on consumption and housing for our economic growth. We borrowed too much, had unsustainable trade deficits and did not invest enough in business capital. The good news today is that we are making headway in shifting the mix of growth in our economy.

Our manufacturing sector is recovering as we export more and as our entire economy invests more in equipment and software. In the long run, that will raise our productivity and our living standards. And that's the kind of recovery that not only will restore jobs, but also will be more sustainable and will help bolster our standard of living.

Price Stability

Shifting to prices, we have seen inflationary impulses gaining ground both at home and abroad. An astute reader of today's *Wall Street Journal* would have noted the article on page A12.¹ It reported the data released yesterday by the Organization for Economic Cooperation and Development—the OECD—showing that consumer prices in its 34 member countries rose 2.7 percent in the last 12 months, driven largely by food and energy prices. Of note, industrial producer prices in the European Union rose 6.7 percent year-over-year—the steepest annual increase since September 2008, just as the financial panic broke the back of the inflationary thrust that had been gaining steam throughout the summer of that year. At the core of the euro zone, Germany, where unemployment is actually lower than before the financial crisis, wage inflation is pressing up against 3 percent. Retail price inflation in the United Kingdom now exceeds 5 percent, despite very high unemployment. Reported inflation now exceeds 5.0 percent in China, 6 percent in Brazil and 10 percent in India.

In this country, as many of you have experienced firsthand, higher energy and commodity prices have reduced the purchasing power of many households. According to the latest readings, headline inflation increased at an annualized rate of 4.9 percent in March after clocking in at 5.1 percent in February.

Numbers like these will make any central banker's heart skip a beat, especially mine. Yet, here and abroad, a closer look at these numbers will reveal that energy and food prices—notoriously volatile items—make up a significant portion of this increase. This is not to say that these increases are unimportant; they are clearly worrisome, and we are following them closely. But

our job as policymakers is to focus on underlying inflationary pressures, so as to avoid overemphasizing temporary volatility that might lead to faulty conclusions on the economy.

The question one should ask is: What is the best method to measure future inflationary trends? Headline inflation, important as it is in measuring the rise in someone's cost of living, accurately characterizes past inflation but is not as informative as one might think for predicting future inflation. For that—counterintuitive as it might seem—it helps to exclude some of the more volatile components. This is why central bankers around the world pay such close attention to underlying measures rather than the headline number. Underlying price movements are more useful in predicting future inflationary trends.

We at the Dallas Fed came up with a separate and distinct way of calculating core inflation, called the trimmed mean analysis. Developed by senior economist Jim Dolmas, this measure looks at the price movements of 178 personal consumption expenditure items that matter to average consumers in a series that goes back to 1977. We then strip away both the highest and lowest monthly price increases for categories of goods and services to get at the underlying trend. This “trimmed-mean inflation rate” has become a key component in my economic toolkit, allowing me to better gauge the direction and speed of approaching inflationary winds.

Over the past six months, the trimmed-mean inflation rate, while rising, has run at a somewhat sedate rate of 1.3 percent, though it has risen from a low of 0.7 percent in mid-2010. The 12-month inflation rate rose from a low of 0.8 percent in the second half of 2010 to 1.1 percent most recently. These numbers excluded items with extreme price increases, such as gasoline and many food items. We also trimmed out items with extreme price declines, such as toys, natural gas and wine. Among the items that were included to ascertain the underlying trend of prices were physician services, rent, tobacco, dining out, the costs of life and health insurance, sporting goods, guns and ammunition and child care costs. As the son of an Australian, I noted that the median item—the one smack in the middle—was beer! I also noted that the number of falling items in the basket has been declining to what has been a historically normal level of about 30 percent of items people consume. This trend in the number of items actually declining in price has been in place for a while, which is what convinced me early on that the risk of deflation was not as high as some of my other colleagues at the FOMC surmised.

The point is that, as of now, the higher gas and commodities prices have not translated into more general price inflation numbers. My gut, however, tells me that we must not become complacent on this front. We know from anecdotal soundings that American businesses, like businesses in other countries, are doing their utmost to offset with higher prices the surging costs of inputs such as fuel, other commodities and materials, and components, parts and processes sourced from abroad. As Chairman Bernanke mentioned in his press conference last week, our job is to keep these from passing into prices and wages throughout the economy and creating a broader inflation. Such a result would be much more difficult, and painful, to extinguish.

We are committed to keeping inflation low and maintaining the credibility gained so painstakingly by former Fed Chairman Paul Volcker. I will remain steadfast in my resolve to keeping inflation low and stable. In monetary parlance, I am known as an inflation hawk—a description with which I am comfortable. As I have pointed out many times, ornithologists classify doves as being from the pigeon family, and I do not wish to be anybody's pigeon. Nor am I alone in my firm commitment to keeping inflation under control. As Chairman Ben

Bernanke commented during last week's inaugural press conference, if we are going to have success in creating a long-run sustainable recovery with lots of job growth, we must keep inflation under control. I am confident in our ability to do so.

So, bottom line: With regard to the economy, like the music of Wagner, the pace of economic growth may not be as *bad* as it sounds. With regard to inflation, like gangsta rap, it may not be as *good* as it sounds.

To counter the recession and ward off the risk of deflation, the Federal Reserve has provided a great deal of stimulus to the economy in the past few years. In my view, we have done as much as we can to supply the liquidity needed to restore economic growth. Now, as Ben Bernanke made clear in his press conference last week, we must remain sharply attuned to movements of underlying inflationary forces. Should it prove necessary to counter inflationary pressures, I will be among the first to advocate the unwinding of some of the stimulus we have provided and returning monetary policy to a more normal stance.

Thank you.

¹ "Developed Nations' Inflation Increases," by Paul Hannon, *Wall Street Journal*, May 4, 2011.