A Report on the Economy
(With a Nod to the Carl Sewells and Ben Bernanke)

Remarks before the Texas A&M Retailing Summit

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The views expressed are my own and do not necessarily reflect official positions of the Federal Reserve System.
Thank you, Cheryl [Bridges] for that kind introduction. Carl Sewell called me some months ago and invited me here today. Carl and I are the closest of friends. And our two sons, “Little Carl,” as I affectionately call him, and my son Miles are also best buddies. No one on the planet is better at making a sale than Papa Carl and Little Carl, so this is why you are stuck with me as your morning speaker.

This morning I would like to provide an overview of the national economy and inflation as we see it from the Federal Reserve Bank of Dallas. Before doing so, however, allow me to demystify the Federal Reserve System and the Dallas Fed’s role within that System.

Federal Reserve Functions

If you look closely at the face of any $1 note, you will see a letter in the middle of the left side. Every $1 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 Fed. 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—the number “11” is printed in all four corners of the bill. The Dallas Fed is responsible for the administration of the Federal Reserve’s affairs in the 11th of 12 districts that were set up by Congress under the Federal Reserve Act of 1913. Presently, there are nearly $1 trillion worth of Federal Reserve notes in circulation. (Of course, you know that the Eleventh District’s dollars—what I call “Texas 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 $110 billion bank. That bank operates at a profit—a profit that we send to the Treasury. Indeed, the 12 Federal Reserve Banks, collectively, transferred over $125 billion to the Treasury in 2009 and 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 second quarter of this year, the Dallas Fed distributed and received almost 2.9 billion circulating banknotes, worth over $53 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 your customers 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 pluck out about 35 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 stopped processing 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 their electronic counterparts, the Federal Reserve Board decided to consolidate all paper-check processing at 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.)

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 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. Activity levels at the discount window vary with changes in the economic environment. For example, in 2009, during a time of duress, the Dallas Fed made 594 loans approximating $30 billion. In 2010, after Texas had come out of recession, we made only 156 loans for about $3 billion. I chair our credit committee and personally review the loans we make every evening.

Among our other responsibilities is supervising the banking industry within our district. Currently, we supervise 37 “state member” banks and 523 bank holding companies. Last June—thanks to the Dodd–Frank Act—we took on the responsibility of supervising savings-and-loan holding companies. We currently have 23 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: Know your customer. 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 issues within our economy. Not unimportantly, we work with universities and high schools throughout our district.

Currency processing, lending as a banker’s bank, banking supervision 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 holdups in the nomination and confirmation process by the Senate), 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, mortgage and other markets during the recent financial crisis. Our more recent initiatives are commonly known as “QE2” and “Operation Twist.”

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 Dallas Fed board members—including Chairman Herb Kelleher of Southwest Airlines and Mike Ullman of J.C. Penney—by businesses that populate my district and by a group of CEOs from around the nation 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 adviser to our research team in Dallas for the past 15 years, won the Nobel Prize in economics in 2004 (and despite that, offers sensible advice).

The FOMC is one of the few public service decisionmaking bodies in the country whose 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 then release a lengthy set of minutes of our deliberations three weeks after our meeting. The minutes of our most recent meeting will be released on Oct. 12. I urge those of you who wish to dig beneath the headlines and better understand the deliberations of the committee, including the views of those like me, who dissented in supporting “Operation Twist,” to pull the minutes off the web. They are only 12 pages long and are readily readable.

The subject of dissent needs to be placed in context. 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: Like the 11 other Federal Reserve Bank presidents, 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. 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.

In keeping with that spirit, there are times when I (and other Bank presidents) take a different view of the cost/benefit analysis of proposed initiatives acceptable to a majority of the
committee, judge the costs to outweigh the benefits and respectfully cast a dissenting vote. This is in keeping with the culture of the FOMC. When I was offered the job of running the Dallas Fed by its board, I was asked to come see then Fed Chairman Alan Greenspan. He said, “Richard, one thing is required of you if you accept this job.” I thought: Aha, now I’m going to learn the secrets of the temple. Then he said, “You must always speak to the truth.” And that’s what each member of the FOMC does: We call ’em as we see ’em, whether or not our positions are popular or politically acceptable. At times, we just have an honest difference of opinion, and as Eisenhower once said, “Never confuse honest dissent with disloyal subversion.” Each and every member of the FOMC, hawk or dove, dissenter or validator of the majority, is totally loyal to the mission of the Federal Reserve.

Economic Overview

So what is my honest view of the current economic situation?

Overall, the data show that Texas continues to grow at a modest pace. *Our* data show Texas gained 13,700 jobs in August after adding 29,300 in July, bringing the total number of jobs created here to 171,200.¹ Year to date through August, our fellow Texans have accounted for 20 percent of the nation’s overall net private-sector job creation. (If you calculate Texas’ contribution to job creation by lopping off those states that have continued losing jobs and consider only those that have positive growth in employment, Texas has accounted for 15 percent).

In order to more effectively gauge the health of our regional economy, I keep a close eye on both the manufacturing and service sectors in our district. Texas accounts for 10 percent of our nation’s manufacturing output. The Dallas Fed conducts the Texas Manufacturing Outlook Survey to track this industry, and according to the most recent survey, Texas factory activity increased in September. The production index, a key measure of state manufacturing conditions, rose, suggesting growth picked up last month after stalling in August. Expectations regarding future business conditions, however, were generally less optimistic in September. The index for future company outlook fell as well, staying positive but registering its lowest reading in more than a year. This tells me that considerable uncertainty is hampering the confidence of our manufacturers.

While we have good reason to be proud of our manufacturing prowess, the main driver of the Texas economy is the service sector. The service sector accounts for almost 60 percent of private-sector output and employs close to 7 million hardworking Texans. To understand trends in the service sector, we conduct the Texas Service Sector Outlook Survey, covering 230 service-providing firms. According to the most recent survey, Texas service-sector activity increased in September. The revenue index, a key measure of state service-sector conditions, climbed, with one-third of respondents noting that revenue increased from August. Indexes of future service-sector activity remained in positive territory in September. However, expectations regarding future business conditions were mixed. The index of future general business activity edged down to its first negative reading since April 2009. The index for future company outlook fell as well, staying positive but registering its lowest reading in more than a year. This tells me that considerable uncertainty is hampering the confidence of our manufacturers.
Of particular interest to this audience, our service-sector survey has a breakout for the retail sector. Retail sales increased in September, according to business executives surveyed, marking two consecutive months of sales growth. Thus, I was not surprised to read this morning that retail sales tracked by Thomson Reuters rose 5.1 percent in September.

Indexes of Texas retail-sector activity remained in positive territory in September, with the exception of part-time employment and hours worked. Expectations regarding broader economic activity improved slightly, although the index of general business activity remained negative.

I should add that we are always looking for ways to improve the accuracy of these surveys. As such, if any of you would be interested in participating in these surveys, please contact me or my staff.

The bottom line is that the Texas economy continues moving forward, albeit at a slower pace. Nationally, the data are less sanguine. This morning’s payroll report of a gain of 103,000 jobs in September serves only to partially offset the slight gains in the June and August nonfarm payroll reports. The problem remains that we have far too many people out of work and for too long.

Price Stability

Shifting to prices, we continue to see inflationary pressures both at home and abroad, although less so than in the spring. An astute reader of Tuesday’s Wall Street Journal would have noted the article by Ann Zimmerman—who I understand is in the audience today—on page B1.2 Zimmerman reported that “apparel stores face a double whammy. Many had hoped to raise prices this fall to recoup the cost of cotton, which soared last year and hit historic highs in March before a recent pullback. Now they worry that strapped consumers will resist price increases. If purchases stall, retailers will have to resort to cutting prices instead.”

Zimmerman correctly identifies the major issue facing many of the retail contacts nationwide whom I consult before every FOMC meeting. Higher energy and commodity prices have reduced the purchasing power of many American households, many of which continue to suffer from the scourge of unemployment and/or are working to de-lever from over-indebtedness. According to the latest readings, headline inflation increased at an annualized rate of 3 percent in August as measured by the personal consumption expenditures (PCE) price index and 3.75 percent as measured by the Consumer Price Index.

Numbers like these will make any central banker’s heart skip a beat—especially mine. Yet a close 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; clearly they are 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 about the course of 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. That 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.

To that end, the Dallas Fed has come up with a separate and distinct way of calculating core inflation, called the Trimmed Mean PCE analysis. This measure looks at the price movements of 178 items in the consumer basket through a constantly updated series dating 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, trimmed-mean inflation has run at a rate of 2 percent. This suggests that headline inflation will likely gravitate down toward 2 percent, a level that the majority of the FOMC believes is a tolerable target.

The point is that, as of now, higher input prices have not translated into more sustainable general price inflation numbers. We know from anecdotal soundings like Ann’s that American businesses, including retailers, are doing their utmost to offset with higher prices what have been the surging costs of inputs. The issue, which remains unresolved, is whether or not consumers have the wherewithal to take on these price increases. The dubious outlook for employment raises doubts about businesses pricing power.

Our job as central bankers is to keep broader inflation at bay. I remain on constant watch for signs of inflationary impulses. But, presently, I believe the most urgent issue is creating jobs and reducing unemployment.

In his testimony before Congress on Tuesday, Chairman (Ben) Bernanke noted that, “Monetary policy can be a powerful tool, but it is not a panacea for the problems currently faced by the U.S. economy. Fostering healthy growth and job creation is a shared responsibility of all economic policymakers, in close cooperation with the private sector. Fiscal policy is of critical importance … a wide range of other policies—pertaining to labor markets, housing, trade, taxation, and regulation, for example—also have important roles to play.”

I have argued this for a couple of years, so I obviously concur with Chairman Bernanke.

The Federal Reserve has done a great deal to reverse the financial and economic crisis we confronted in 2008 and 2009. We have filled the gas tanks of the economy with affordable liquidity. What is needed now is for employers to confidently step on the pedal and engage the transmission that will use that fuel to move the great job-creating machine of America forward. If I believed further accommodation or fiddling with the yield curve would do the trick and ignite sustainable aggregate demand, I would support it. But the bar for such action remains very high for me until the fiscal authorities do their job by reducing the fiscal and regulatory uncertainty that is holding our mighty economy back.

Cheryl, I think I have said enough. So I will end on that, and now do my best to avoid answering any questions you might have.

Thank you so much.
Notes

1 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, the Dallas Fed rolls in this better information every quarter as it becomes available. Thus, Dallas Fed data are less subject to major annual revisions.
