

Where Have We Been and Where Are We Going?

(With Reference to Wodehouse's Lead Pipe, Saint Willibrord's Shuffle, Munch's *Scream* and Sarah Bloom Raskin's Sink)

Remarks before the Austin Chamber of Commerce



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Austin, Texas
December 16, 2011

The views expressed are my own and do not necessarily reflect official positions of the Federal Reserve System.

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Thank you, Bobby [Jenkins]. It is an honor to speak at the 2012 Economic Forecast Luncheon. I am a poor substitute for the last of my Federal Reserve brethren to appear before this chamber—Ben Bernanke. The chairman would have enjoyed congratulating the brave souls from four of our leading universities who ventured forth last year to make their winning forecasts, which you have celebrated here today.

It is noteworthy that even the winners of this year's forecasting sweepstakes were not insignificantly off the mark of what actually occurred in the national economy, with the exception of Dr. Gardner's and Dr. Gilligan's spot-on forecast for the prime rate. We know from our experience on the Federal Open Market Committee (FOMC) that forecasting the economy these days has become difficult. During the course of the year, we saw large shifts in the outlook for growth, inflation and unemployment, reflecting the obvious fact that we are in an unfamiliar and rapidly changing economic environment. My undergraduate economics professor, John Kenneth Galbraith, used to chide that "the only function of economic forecasting is to make astrology look respectable." Even though they were not spot-on, today's forecast winners make economists look respectable, and I thank them for it.

I hesitate to single out any one winner but I am compelled to do so, as Tom Saving is the father of Jason Saving, one of our very able economists at the Dallas Fed. The sins of the father have been visited on the son! Happily, so has a great virtue. In a recent *New York Times* article, Greg Mankiw wrote, "A prerequisite for being a good economist is an ample dose of humility."¹ Like father, like son—Saving Senior and Junior both share a sense of humility, which is why I respect both of them so much.

This has been a remarkable year. The great comedic writer P.G. Wodehouse pretty much summed it up when he wrote that "just when a (fellow) is feeling particularly braced with things in general ... Fate sneaks up behind him with a bit of lead piping."²

At the beginning of this year, I felt pretty confident, if not exactly "braced," that we were on the path to recovery, albeit I projected a slow, jerky one. My forecasting skills are certainly not on par with those honored here today. But I am on record for calling the bottom of the recession in an interview published in the *Dallas Morning News* on Aug. 26, 2009, some 15 months before the official arbiter of recessions and recoveries—the National Bureau of Economic Research (NBER)—did. NBER pegged the beginning of the recovery as occurring at the beginning of the third quarter of 2009.³

At the time, I stated that while the recession may be over, the recovery would be a "slow slog." My colleague, Mark Wynne, director of the Dallas Fed's Globalization and Monetary Policy Institute, is fond of citing the ceremony that honors Saint Willibrord, the Catholic Church's patron saint of convulsions. Every year in Luxembourg, there is a Willibrord procession. Participants proceed in a shuffle, taking two steps forward, then one step back. One might say

that we at the Dallas Fed envisioned a Willibrord-like recovery—one that would be halting and given to occasional reversal and convulsions. However, barring some exogenous shock, we forecast the recovery would proceed slowly, gaining momentum over time. This is indeed what has occurred, despite the doubters and skeptics, over the past two years.

In a nutshell, my vision has been as follows: In 2008, businesses were experiencing cost-push pressures. They discovered they could not price the goods and services they were selling aggressively enough to match rising production costs. Headline inflation for both June and July 2008 was scored at an annualized rate of 11 percent, as measured by the Consumer Price Index; the 12-month rate in July 2008 was 5.5 percent—the highest level since January 1991. Driven by fear that inflation was beginning to systematically take root, and aided by an acceleration in the ability to harness productivity-enhancing technology and more sophisticated exploitation of globalization, businesses began to focus in earnest on cost containment. They began this process with their largest cost center, labor. When the Panic of 2008–09 struck in late summer, they doubled down on their cost-control initiatives. Final demand imploded; pricing power vanished; the prospect of top-line growth evaporated. To preserve margins, cost-control management became even more aggressive, with the result that labor took it in the neck and unemployment skyrocketed.

Today, over three years into this dynamic, businesses remain cautious about cost control and adding significantly to payrolls and job-creating domestic capex. This is despite being awash in liquidity. The Federal Reserve has flooded the markets with cheap, readily available money. The private sector, the wellspring of productive job creation, now has the financial means to grow employment. But it lacks the incentive to do so.

If anything, I feel that my colleagues on the FOMC have exceeded the amounts necessary to fuel the needs of job creators. I balked at pledging to hold rates low through mid-2013, and felt that “Operation Twist” would be of doubtful efficacy except in making some quick profits for those market players who bought on the (regrettably too well circulated) rumor and sold on the news of the FOMC announcement. Despite what the *Wall Street Journal* wrote under my picture in Wednesday’s edition, I did not “vote (twice) against FOMC moves to push down long-term rates for fear they would generate inflation.”⁴ I am, and always will be, a “hawk” on the inflationary front. But I voted against those initiatives because I felt that under the circumstances, they would do little to encourage job formation.

Within the FOMC and in many public speeches, I have argued that based on anecdotal soundings from the businesses I survey, and applying the rigorous analysis we do at the Dallas Fed in calculating the Trimmed Mean for Personal Consumption Expenditure (PCE), inflation would likely move toward the 2 percent range as the year wore on.⁵ The Consumer Price Index (CPI) report issued this morning confirms that downward trend (so Tom Saving might wish to revise his forecast down from the 4.5 percent he predicted for 2011). Today’s CPI report appears to confirm our expectation. I expect that companies who pushed through prices rather aggressively in 2011 will likely effect rollbacks in 2012, mitigating the headline price pressures we experienced this year. I have argued as much at the FOMC table.

My reluctance to support greater monetary accommodation has been based on efficacy: With businesses’ cash flow—driven by record high profits and bonus depreciation—at an all-time high, both absolutely and as a percentage of GDP; with every survey, including those of small

businesses, indicating that access to capital is widely available and attractively priced;⁶ with balance sheets having been amply reconfigured; and with bankers and nondepository financial institutions sitting on copious amounts of excess liquidity, I have argued that further accommodation was unlikely to motivate the private sector to put people back to work. It might even prove counterproductive should it give rise to fears the Fed is so hidebound by academic theory as to be blind to the practical consequences of harboring an ever-expanding balance sheet. This inevitably raises concerns we are creating distortions in the fixed income markets that inhibit proper market functioning, or concerns that—despite our protestations to the contrary—we are given to monetizing the government’s debt, an impulse that ultimately destroys a central bank’s credibility.

I have argued that other, nonmonetary factors are inhibiting the robust job creation we all seek.

One of the inhibiting factors is the palpable concern about the future of final demand. It has slowly begun to strengthen domestically, yet developments in Europe, a slowdown in growth in emerging economies such as China and Brazil, and concerns about financial trip wires that might be triggered, give rise to caution. On the foreign front, we are innocent bystanders: There is little we can do but pray that fiscal and monetary authorities abroad get it right. So far, their moves have been less than reassuring. The Chinese have not provided convincing proof that they will be able to contain the pricking of their real estate bubble or the shadow banking industry that enabled it. This has led some to posit that Chinese growth may slow beyond the consensus expectation of China watchers. And as for the Europeans, one might say in the spirit of the season that when analysts opened the present wrapped and re-bowed by Angela Merkel and Nicolas Sarkozy in Brussels last week, it included that dreaded little note saying “assembly required,” had at least one part, Britain, missing and others—Sweden, Hungary and the Czech Republic—that may not fit.

One of the Dallas Fed’s astute economists, John Duca, has lately adopted the mantra that “Main Street Heals While Kaiser Street Reels” (29 Kaiserstrasse is the European Central Bank’s address). Recent real side indicators and financial market movements indicate a striking dichotomy between improving economic indicators here at home and signs that financial markets and economies continue to sour on the other side of the Atlantic. Thus, just as we had come to see the light of an evolving domestic recovery, one senses Europe, and possibly the emerging economies, sneaking up behind us, Wodehousean-pipe in hand, poised to knock us off course.

The brows of economic forecasters and business operators begin to furrow when contemplating the international landscape. But the face of both the economist and businessman turn into something akin to Edvard Munch’s *Scream* when contemplating the frightful consequences of indecision and political mischief at both ends of Pennsylvania Avenue in Washington.

I maintain that no matter how much cash you have on your balance sheet, or how compliant your banker might be, or how cheap the cost of money, you will not commit substantial capital to expanding your payroll or investing significant amounts to expand plant and equipment until you know what it will cost you to run your business; until you know how much you will be taxed; until you know how federal spending will impact your customer base; until you know the cost of employee health insurance; until you are reassured that regulations that affect your business will be structured so as to incentivize rather than discourage expansion; until you have concrete assurance that the fiscal “fix” the nation so desperately needs will be crafted to stimulate the

economy rather than depress it and incentivize job creation rather than discourage it; or until you are reassured that the sinkhole of unfunded liabilities like Medicare and Social Security that Republican- and Democrat-led congresses and presidents alike have dug will be repaired so that our successor generations of Americans will prosper rather than drown in dark, deep waters of debt.

My colleague Sarah Bloom Raskin—one of the newest Fed governors, and a woman possessed with a disarming ability to speak in non-quadratic-equation English—recently used the example of the common kitchen sink to illustrate a point. I am going to purloin her metaphor for my description of our present predicament. You give a dinner party. The guests leave and you are washing the dishes. When you are done, you notice the remnants of the party are clogging the sink: bits of food, coffee grinds, a hair or two and the like. You have two choices. You can reach down and scoop up the gunk, a distinctly unpleasant task. Or you can turn the water on full blast, washing the gunk down the drain, providing immediate relief from both the eyesore and the distasteful job of handling the mess. You look over your shoulder to make sure your kids aren't looking, and, voilà, you turn the faucet on full blast, washing your immediate troubles away.

From my standpoint, resorting to further monetary accommodation to clean out the sink, clogged by the flotsam and jetsam of a jolly, drunken fiscal and financial party that has gone on far too long, is the wrong path to follow. It may provide immediate relief but risks destroying the plumbing of the entire house. It is a pyrrhic solution that ultimately comes at a devastating cost. Better that the Congress and the president—the makers of fiscal policy and regulation—roll up their sleeves and get on with the yucky task of cleaning out the clogged drain.

The former prime minister of New Zealand, Mike Moore, has written a book titled *Saving Globalization: Why Globalization and Democracy Offer the Best Hope for Progress, Peace and Development*. He dedicates it “to honorable public servants, elected or otherwise” and adds a quote from Martin Luther King Jr. To remind them of their ultimate duty as leaders of democratic societies, King said:

“Cowardice asks the question—is it safe? Expediency asks the question—is it politic? Vanity asks the question—is it popular? But conscience asks the question—is it right? ... There comes a time when one must take a position that is neither safe, nor politic, nor popular, but one must take it because it is right.”⁷

That time is now. Our nation's economy is at risk. The Federal Reserve has done everything it can to reduce unemployment without forsaking our sacred commitment to maintaining price stability, or crossing over the monetary river Styx into full-blown debt monetization. I personally don't care which party is in the White House or controls Congress. All I know is that the “honorable” members of Congress and presidents past, Republicans and Democrats alike, have conspired over time, however unwittingly, to drive fiscal policy into the ditch. They purchased their elections and reelections with popular programs so poorly funded that they now threaten the economic well-being of our children and our children's children. Instead of passing the torch on to the successor generation of Americans, they have simply passed them the bill. This is the opposite of honorable.

Like all of you here, I am sickened by our politicians' tendency to kick the can down the road, even when it is starkly clear that doing so jeopardizes America's well-being. Small wonder that

some recent polls show only 9 percent of the American people view Congress favorably. (One senator posited that the 9 percent consisted of blood relatives and congressional staff!)

But this is the holiday season, and especially now, I am given to viewing the world through optimistic eyes. The Christmas spirit may be overwhelming my judgment, but I believe that the American people—from the mainstream to the Tea Party to the unemployed and disaffected who have taken to the streets—are in the process of forcing politicians to get their act together. There is a loud, distinct, clarion call for leadership—for the people we entrust to right the rules that determine our economic future, cast away cowardice, expediency and vanity, and get on with leading us out of our fiscal wilderness.

At this time of year, I always count my many blessings. My brother, Mike, is here today; he has finally seen the light and has moved to Texas after a long and successful career in institutional asset management in New York and California. I admire him for more than his professional accomplishments. We experienced some rough times when we were kids, and he always stepped into the breach, forgoing the pleasures of his teenage years by working tough jobs so he could pay the rent and put food on our family table when things were not going well for our father. Thanks to Mike, we survived those difficult times and went on to live the American dream.

My brother and I know how blessed we are that our parents chose to immigrate to this great country. They came here because there was no limit to upward mobility; they came to the United States because it was the land of milk and honey; because they knew that here, their children would live better lives than they lived; that there was no limit to what anybody with determination and the lucky break of being an American could accomplish. Mike and I have lived out our parents' dream. There is no reason why any American child today should not have that same opportunity.

If the American dream is to survive, we will need to re-create a fiscal and regulatory environment that—in conjunction with the Fed conducting prudent monetary policy—will liberate the forces of entrepreneurial risk taking that have always been America's hallmark, and that allowed successor generations to live far better lives than their parents ever thought possible. Only then will we get back to generating the jobs and the prosperity for all of our people, not just for financial sharpies. Only then will we restore faith in the prospect of upward mobility for all, not just the few. And only then, with the nation's economy firmly back on a trajectory of promise and prosperity, will we feel "braced" with confidence that no force can dislodge by sneaking up behind us with a proverbial lead pipe.

Bobby, I thank you and this wonderful audience for your time. Now, in the best tradition of central banking, I would be happy to avoid answering any questions you might have.

Notes

¹ "Know What You're Protesting," by N. Gregory Mankiw, *New York Times*, Dec. 3, 2011.

² "Jeeves and the Unbidden Guest," by P.G. Wodehouse, *Saturday Evening Post*, 1916.

³ "Recession Over, Dallas Fed Chief Says, but Jobs Lag," by Brendan Case, *Dallas Morning News*, Aug. 26, 2009.

⁴ "Fed Sees Economy Gaining But Vulnerable to Big Risks," by Luca Di Leo and Jon Hilsenrath, *Wall Street Journal*, Dec. 14, 2011.

⁵ The Dallas Fed tracks 178 items in the consumer basket through a constantly updated series dating back to 1977. Using this data, we calculate what we call a “trimmed mean” analysis by stripping out items that have had the largest and smallest price increase. We believe this measure does a good job of capturing trends in overall inflation, and it is my preferred compass for charting the direction of inflation. The most recent analysis can be found at www.dallasfed.org/data/pce/index.html.

⁶ See Small Business Economic Trends survey, National Federation of Independent Business, www.nfib.com/research-foundation/surveys/small-business-economic-trends.

⁷ *Saving Globalization: Why Globalization and Democracy Offer the Best Hope for Progress, Peace and Development*, by Mike Moore, Hoboken, N.J.: John Wiley and Sons, 2009.