Speeches by Bob McTeer

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It's a pleasure to be here on this bittersweet Thanksgiving Day in the U.S. and to participate in your seminar on Adam Smith and economic development in the 21st century. I'm obviously an Adam Smith fan, as you can tell from my tie and cuff links. The Dallas Fed's 1999 annual report contains a picture of me visiting Adam Smith's grave in Edinburgh. It also shows me at Buddy Holly's grave in Lubbock, Texas. Buddy Holly was a 1950s rock and roller. Buddy Holly probably sold more records than Adam Smith sold books, but *The Theory of Moral Sentiments* and *The Wealth of Nations* may endure longer than "Peggy Sue" and "Rave On." Only time will tell for sure.

I look forward to visiting places that Adam Smith visited in Paris. I was in France last summer to pay tribute to the French Adam Smith—Frédéric Bastiat—who was born 200 years ago this year. The title of my speech at the Bastiat conference in Dax was "Why Bastiat Is My Hero." If you are interested, you can find my speech and an op-ed piece on Bastiat on the Dallas Fed's web site, at www.dallasfed.org.

In the 1840s Bastiat fought for liberty in its many aspects, but especially freedom to trade. He wrapped his great wisdom in wit and satire. The best example of that was his tongue-in-cheek petition to the French Parliament on behalf of the French candlemakers, urging the passage of a law requiring everyone to close their blinds and shutters to shut out the sunlight because it unfairly competed with the candlemakers in the production of light. He detailed all the direct and indirect benefits of shutting out the sun and stimulating domestic candle production. We hear similar protectionist arguments today that—sadly—are not intended as satire. We need Adam Smith and Frédéric Bastiat to enlighten the trade debates going on today.

Bastiat is also famous for the "broken window fallacy" in his essay on the seen and the unseen. It seems that some unruly teenagers threw a brick through a baker's window. What a shame, said the gathering crowd. But soon they thought they saw a silver lining in the situation: The baker's expenditure to fix the glass will generate income for the repairman, who will, in turn, spend his additional income with someone else. The silver lining is that the broken window will generate a good bit of economic activity for quite a few people. Like the repair work following a hurricane.

But wait a minute, said Bastiat. If the baker hadn't had to spend his money on window repair, he could have spent it on something else, generating a similar stream of spending and income. The economic activity initiated by the broken window was real. It was seen. What could not be seen was the economic activity that would have otherwise occurred. The broken window didn't create new income and jobs; it just diverted them. Bastiat rescued common sense: Broken windows are bad. Hurricanes are bad. And even in a narrow economic sense, destruction caused by terrorism is bad. There is no silver lining.

After the longest economic expansion in its history—10 years—the U.S. economy slowed abruptly last year. GDP growth decelerated to almost zero in this year's second quarter. A collapse in investment spending and manufacturing output was slightly more than offset by continued strength of consumption spending, especially on services, keeping the GDP numbers barely positive through this year's second quarter.

Dallas Fed economists estimate that before the September 11 attack, we were on track to post another small but positive growth rate in the third quarter. The first estimate of the third quarter decline came in at 0.4 percent. That number will likely be revised downward somewhat. The consensus is that the decline in the current quarter will be significantly larger, probably the largest of the recession that is now inevitable.

While I think that before September 11 we still had a shot at avoiding two negative GDP quarters, a recession is now likely to be called officially by the National Bureau of Economic Research and the date they put on it is likely to be earlier than the third quarter. My guess—and it's only a guess—is that they will put the peak date of the business cycle at March 2001, when total employment peaked. Industrial production peaked earlier and has now declined for 13 months, but until last March, growth in the broader economy was sufficient to sustain total employment.

The more important question now is when the trough, or bottom, of the downturn will occur. When will economic activity bottom out and growth resume? Let me be clear that I'm talking about the United States here. Europe and some other parts of the world still have a chance to avoid a technical recession, despite a significant slowing of growth.

Unfortunately, however, most of the trading world has either slowed significantly or gone into actual decline, making it more difficult for the United States to rely on other countries as engines of growth. It is difficult for two friends, both standing in quicksand, to help each other. Those countries not yet fully in the quicksand should find some hard ground as soon as possible and lend a hand, for their own sake as well as for the sake of the community of nations.

The U.S. slowdown was very unusual, at least by modern standards. The "New Economy"—Yes, Virginia, the New Economy was real—featured an investment boom based on new productivity-enhancing technology. Technology, after long appearing to make little difference, started making a huge difference in the mid-1990s. Productivity growth increased significantly, which raised the real growth potential of the economy—the speed limit—and allowed much lower unemployment levels without accelerating inflation. Until late in the game, faster growth and lower unemployment were met with lower, not higher, inflation rates.

During this New Economy period—up to the middle of last year—investment's share of national spending rose significantly, as did profit's share of national income. Many people were calling our "Goldilocks" economy unsustainable, which didn't make much sense to me because it had been sustained for over four years.

The irrational behavior of the stock market was never part of my vision of the New Economy, so when the high-tech stock bubble burst in the spring of 2000, I didn't consider that the end of the New Economy, or even the beginning of the end. I believe I said something to the effect that the stock market may have been in a bubble, but not the economy.

In retrospect, I suppose the investment sector of the economy—especially the high-tech sector—had gotten ahead of its customers and was in something of a bubble. Perhaps it is part of the nature of new technology that much of the experimenting leads in multiple directions until the "right" direction becomes clear. I'm told that overinvestment was especially the case in the telecom sector, where different, competing standards led to duplication and overinvestment. I have a friend who worked at Lucent. I asked him what happened—Lucent was riding high one minute and in a downward spiral the next. He said it was a wrong bet on technology. Up-front standard setting may be an area where we in the U.S. could learn from our European friends, although I'm still leery of the dangers of "picking winners," as we Bastiat types like to say.

When people ask me where the impetus for recovery is likely to come from, I don't have a good answer. Consumer spending has to hold up until investment spending can get back on track. It's easy to argue that the consumer is close to being "borrowed up and bought out." And our low personal saving rate suggests a need for consumers to save more rather than spend more.

Retail sales in October showed the largest increase ever, on the strength of automobile sales sustained by special, no-interest financing. That's helpful during this emergency period, but it's hard to avoid the conclusion that it's borrowing sales from the near future, even if profitless sales could be sustained longer by the selling companies.

The other question is, When can investment spending—especially high-tech investment—come back, given its strong downward momentum and low capacity utilization rates? My only observation on this point is that not all new investment is to increase production capacity. Much of it—especially the productivity-enhancing kind—is to reduce production costs, especially labor costs.

To me, the best reason to expect a recovery is that we have always had a recovery in the past, and the slowdown is already over a year old. The next reason is that monetary policy has been very aggressive for almost a year now. The FOMC has reduced its target federal funds rate—our interbank rate—from 6.5 percent at the beginning of the year to 2 percent currently. One and a half percentage points of that reduction have come since September 11. I don't know about you other central bankers, but a 2 percent interbank rate seems pretty low to me. Our largely token discount rate has been brought down from 6 percent at the beginning of the year to 1.5 percent currently.

I say "token" because under normal circumstances, borrowing has been at low levels in recent years and not a significant source of reserves to the banking system. That does not mean that access to the discount window—as opposed to the rate—is not an important safety valve. It is, especially during periods of stress when the central bank's function as lender of last resort comes into play.

In fact, during the days following the September 11 attack, the Fed provided massive amounts of liquidity to the markets through regular open market operations, lending at the discount window and through the provision of check float. Discount window lending was particularly important in keeping electronic payments flowing when computer and communications systems rendered major participants unable to receive expected payments. By temporarily borrowing the funds from the Fed to make their own payments, gridlock was avoided. Think of the funds provided through the discount window as a temporary bypass while the main arteries of the payments system were being repaired. Once the repairs were made, the loans were repaid with the normal flow of funds. Acting as lender of last resort during emergencies is an important central bank function, but it is not the part of monetary policy that I am describing here.

Despite the reduction in nominal rates at the short end of the yield curve, there is still some debate about the true extent of monetary easing in the United States. Monetarists who focus on money growth and monetary base growth look at our numbers and conclude that policy may have eased too much. Those who focus on market-based indicators of policy don't share that opinion. They point to the strong dollar on foreign exchange markets and continued low—and in some cases, falling—commodity prices, including gold. They and others point out that with inflation falling by many measures, the low nominal federal funds rate still leaves the real federal funds rate in positive territory. In the last recession, the 3 percent low in the federal funds rate matched the 3 percent inflation rate to produce a zero rate in real terms.

Additional ambiguity is provided by the fact that long rates have not matched the declines in short-term rates and that less than top-quality debt contains significant risk premiums. While we can have honest disagreements on the precise extent of monetary easing, that it has been substantial is not in doubt.

Fortunately, we went into this emergency period with significant actual and projected budget surpluses. This has provided room for an appropriate easing of fiscal policy to reinforce the expansionary potential of monetary policy. The rebate portion of the earlier tax cut proved to be very well-timed. Hopefully, the marginal tax rate reductions already in law for future dates can be brought forward and implemented earlier. The tax cuts seemed overly back loaded even before the current emergency. The need to accelerate them is even greater now.

In addition to monetary and fiscal policy, the recent declines in energy prices should help reinforce the impetus to recovery.

Significant declines in inventories that have already occurred help move us to the place where increases in demand will have a near-term response in production.

Finally, perhaps the high-tech information systems that caused the slowdown to be so abrupt will also help businesses detect and respond to a pickup in demand equally rapidly.

In summary, history, monetary policy, fiscal policy, lower energy prices, and reduced inventories and better information offer hope for recovery. I'm not saying recovery is at hand or is imminent. I see no hard evidence of that yet. Meanwhile, we have a higher priority—to prosecute the war against terrorism. Fortunately, that effort will also provide economic stimulus.

In the spirit of Frédéric Bastiat—the French Adam Smith—let me close with an obvious but often overlooked point about the economic impact of the terrorist attack and its aftermath. It goes back to the broken window fallacy.

The recovery efforts and the extra spending on security will generate GDP. But that is not to be confused with standard of living. We will be shifting real resources away from their prior occupations in the private sector into security jobs such as the armed forces, border guards, airport security, big-event security, company security and so forth. This shift is necessary and appropriate. But it will only raise our security back to the level we already had, or thought we had. The real cost will be all the discretionary goods and services we won't have because their producers are moved into security. This increase in the "overhead" cost of the economy will be significant and ongoing. But the GDP statistics will be largely sustained.

An immediate shift of a $10 an hour service worker into a $10 an hour security worker will leave GDP unchanged. But our standard of living will decline. The necessary and appropriate shift of resources will make us all poorer at each level of GDP. People will talk favorably about all the jobs that will be created—all the GDP that will be created. They will talk about silver linings. But they will be wrong. There is no silver lining.

The analogy to the cleanup after a hurricane is imperfect. Homes lost in a hurricane aren't subtracted from GDP while the cost of the repairs are added. That much is the same. But with a hurricane the repairs are made and the extra resources are redeployed elsewhere in the economy. It is temporary. The current war on terrorism has an economic impact similar to other wars. The threat is continuing and so is the cost.

Much of the productivity improvement in the New Economy resulted from the elimination of redundancies. Information and communications technology enabled us to have just-in-time inventories and just-in-time workers. Better, more timely information meant more certainty in production and distribution and hence less need for backups, duplication, etc. This situation will undo some of that. It will move just-in-time toward just-in-case—inventories and other things.

I mention this because not many people do. We've become too GDP-centric, to coin a word.

While this terrorism lowers our standard of living immediately and on an ongoing basis, that doesn't mean growth won't resume. It will, and we will again surpass old living standards. Further, I see no logical reason that the advances in technology and productivity won't continue to be vigorous once the recession is behind us.

While many talented people were lost on September 11, the state of knowledge in the world remains pretty much intact. Moore's law has not been repealed. The recipe books haven't been lost.

The key to future prosperity is not just technology, however, but the people of the world—free and creative. We can't afford to let the impetus to freer trade languish, or the impetus to freer legal immigration. We must remember Adam Smith—both the Scottish and the French versions—and continue to defend liberty and freedom.

The argument between Adam Smith and Karl Marx is over. The good guy won. Which means we all won.

Central bankers don't have the most important role to play, but we do have a very important role to play. We must provide the financial and economic stability that fosters low inflation and maximum sustainable production. That will be our contribution to individual liberty.