Speeches by Bob McTeer

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Thank you. It's an honor to be invited. If I disappoint, you can blame Julie England. If not, it's all my doing.

These past few days I've been wondering how to talk about what I talk about through the prism of transparency. I looked up transparency in the dictionary; I even skimmed *The Transparency Edge*. Somewhere along the way it dawned on me that I've always been a very transparent person. At least, many of the girls I knew in high school and college told me they could see through me. I didn't take that as a compliment at the time.

Your focus has been on transparency in management and leadership, which is outside my scope. What little I know about management and leadership, I learned from the cowboy culture of Texas. First, a good leader should look back occasionally to make sure the herd is still there. Leaders do require followers. Second, always drink upstream and sleep upwind from the herd. And third, never squat with your spurs on.

In my dictionary, the fifth meaning of transparency is "without guile or concealment; open; frank; candid." Of course, these attributes are desirable in life as well as in management, which aren't necessarily two different things. But total let-it-all-hang-out honesty may be even more important for credibility in today's new digital, virtual information economy than ever before.

The power and effectiveness of top management in the old economy was based on a monopoly of information. Information was gathered and processed at the top and then pushed down and across the organization on a need-to-know basis. Only the boss had all the known information and a good view of the big picture. It was hard to argue with the boss because she presumably had information you didn't have or knew something you didn't know. At least that was the presumption.

Not anymore. The top-down model is flawed because it disenfranchises most of the potential contributors to organizational success. Besides, a monopoly on information is no longer possible in today's information economy, where creativity is increasingly our only comparative advantage. "The Internet changes everything" may have been overstated in the late 1990s. But maybe not. The technology did get ahead of the business model and profitability, and we did have a high-tech bubble. But that doesn't mean the revolution wasn't real.

In a world where "to Google" is a transitive verb, the boss can't know it all, and she'd better not pretend she can, or she'll be—pardon the expression—found to be without clothes. Information, and what to make of it, no longer drips; it percolates. If you try to fake it, your herd will see right through you. Sometimes I think my best contribution is to go get the pizza.

Our economy is the most transparent in the world, but it's not as transparent as it should be, we've learned recently. But it's getting there, and in the process, it's becoming even more efficient. The business cycle hasn't been conquered, but it has been weakened: Recessions are fewer, milder and further between. Inflation isn't dead, but it's on the ropes. Our financial markets, the most transparent and efficient in the world, are becoming more so as a result of recent revelations. That also goes for corporate accounting and corporate governance.

As for transparency in policymaking, the International Monetary Fund publishes a code of good practices on fiscal transparency for member countries to follow. The Heritage Foundation in the United States and the Fraser Institute in Canada publish indexes of economic freedom that show remarkable, positive correlations between a country's economic freedom and its growth rate. While economic freedom and transparency aren't the same, they are related. More precisely, transparency appears to limit official corruption, which inhibits growth.

If you weren't on vacation two weeks ago, you saw the result of transparency in monetary policy when the Fed raised its target federal funds rate from 1 to 1¼ percent. Even though that was the first "tightening" in over four years, financial markets yawned. The Fort Worth, Texas, newspaper titled an article, "Fed Rate Hike May Scarcely Be Felt." That's probably true, and the reason is found in a July 6 *Washington Post* headline that said, "Fed Took the Mystery

Out of Rate Hike."

Quoting from the *Washington Post*:

The era of extra-cheap credit began to recede last week when Federal Reserve officials raised a key short-term interest rate for the first time in four years.

Yet no one seemed to blink. Although stocks usually drop when interest rates rise, Wall Street shrugged off the quarter-point increase in the benchmark rate, closing slightly up for the day the increase was announced. Bond prices were similarly unruffled.

The point was not that the slight tightening had no effect, but that the Fed's greater transparency had enabled financial markets to correctly anticipate it and adjust to it gradually prior to the actual move. Most interest rates had already adjusted to the anticipated new fed funds rate.

Again, according to the *Washington Post* article:

The new transparency policy is a marked change from 10 years ago, when the Fed started another rate-tightening cycle to curb inflation, doubling the short-term interest rate from 3 percent to 6 percent in about a year. . . .

In raising rates last week, Fed officials signaled that the central bank may raise rates more as the economy grows stronger, but again said it would do so "at a pace that is likely to be measured."

It's anyone's guess where the Fed will set rates at its next meeting in August, or even a year from now. But if the central bank continues its policy of sending clear signals, getting there could be relatively painless. [End quote.]

Our small policy adjustment two weeks ago ended a prolonged period of extraordinarily easy monetary policy that began on January 3, 2001, in response to a slowing of the economy in the second half of 2000. We eased rapidly from a fed funds target of 6½ percent to 1 percent.

The New Economy of the late '90s contained lots of foam, but it contained lots of beer as well. The fundamental driver that made other good things possible was a doubling of productivity growth from the previous two decades. That enabled faster overall growth and lower unemployment rates, with inflation continuing to decline. Inflation fell so low last year that some people worried it would hamper monetary policy or even morph into Japanese-style deflation.

Public discussion by policymakers of such potential hypothetical problems—consistent with transparency—nevertheless caused some in the bond market to purchase long-term bonds to get ahead of the Fed. They drove down 10-year bond yields to very low levels, and then drove them back up when the threat of deflation dissipated.

That episode may have been a negative effect of transparency, but it led to even greater efforts to be more transparent in our language. For several meetings our announcements indicated that we could afford to be accommodative "for a considerable period." "For a considerable period" later gave way to "patience" for two meetings. Then "measured" emerged, which markets took to mean we might tighten soon but not aggressively, as we had in 1994, when rates doubled from 3 percent to 6 percent in a year. "Measured" was retained in the most recent press release, but a new sentence was added to clarify that while we expect to be measured, we will do what is necessary to keep inflation down.

That's probably more than you wanted to know about transparency in monetary policy. As you can imagine, as the language became more important, we had to spend more time trying to get it right. It's a mixed blessing at best. I'm reminded of the line, If you are silent, you may be misunderstood, but not misquoted.

Let me turn to the economic environment you'll face in the next few years. First, the Fed is determined to hold on to the gains made against inflation in the past decades. If the recent blip up turns out not to be transitory, we will—as the press release implied—do what is necessary, even though "measured" is still my best guess at this point. You probably don't realize it, but my commitment to price stability is significant because I'm supposed to be the Fed's

dove. A dove with attitude, but a dove nevertheless.

Price stability and global competition mean that cost control and productivity enhancements will continue to be necessary for profitability. Fortunately, and amazingly, the productivity boom of the ’90s continued through the recession and actually accelerated during the jobless portion of the recovery. As you know, productivity growth was largely responsible for the dearth of net job growth through last year. You were producing more with fewer workers.

While productivity growth may slow job growth temporarily, it augurs well for future economic growth and rising living standards. The American people, including American workers, in my opinion, will be able to enjoy rapid non-inflationary growth for the foreseeable future.

The gradual squeezing out of inflation has contributed to the productivity boom by forcing businesses to get their profits from efficiency and productivity rather than inflationary price increases—necessity being the mother of invention. Like the Internet itself, productivity growth has been a boon to consumers, but perhaps a bane to business.

We still have a way to go before we use up the slack left over from the recession and restore full employment. The increase of 112,000 net new payroll jobs in June was disappointing after five months of good job growth. But employment growth in the household survey, which is the basis for the unemployment rate, was a much more vigorous 259,000. Yet the unemployment rate didn’t fall from its 5.6 percent level, because the labor force grew by 305,000, reflecting discouraged workers reentering the workforce. That pattern will likely persist for a while, limiting the decline in the unemployment rate despite decent employment growth.

But don’t lose perspective; the peak unemployment rate in this past recession was only 6.3 percent, compared with 7.8 percent and 10.8 percent in the two previous recessions.

A sluggishly high unemployment rate is undesirable in itself, of course, but it also raises the risk of loss of support for continued progress toward freer trade and investment. The recent controversy over overseas outsourcing—a variant of trade—nevertheless shows how people espousing good economic principles can be put on the defensive. Economic literacy takes a hit in tough times.

Central bankers are paid to worry, and there is certainly plenty to worry about in the current economic environment. The budget deficit is way too large and may ultimately become a drag on growth. But if it’s a bad idea, it may have been a bad idea with good timing. The swing from surplus to deficit, as well as the tax cut, certainly helped cushion the recession and boost the recovery. Of course, the deficit was largely produced by the weakening of the economy, and thus tax revenues, just as the earlier surplus was largely the product of the booming New Economy of the late ’90s and the booming stock market. But as we restore full employment and full capacity, spending controls should be restored to allow the acceleration of growth to melt the deficit as a percentage of GDP. I said spending controls, not tax increases.

The large deficit in our trade and current accounts will become a problem some day, even though they are produced largely by the U.S. economy having a growth rate higher than most of our trading partners. Our growth stimulates more imports from our trading partners than their growth stimulates our exports. In addition to differential growth rates, studies appear to show that our imports are more sensitive to growth than are the imports of our trading partners. That makes correcting our international deficit a tough nut to crack. So far, there haven’t been adverse consequences, but to paraphrase the late Herb Stein (Ben Stein’s father), If something is inevitable, sooner or later it will happen.

What would happen is not entirely clear to me, but it would probably have to do with foreigners becoming less willing to keep adding to their holdings of U.S. securities, which would put pressure on our interest and exchange rates. Meanwhile, our current account deficit enables us to absorb more goods and services than we produce. Ultimately, we will have to produce more than we consume to service the accumulated international debt. So don’t become complacent. Go forth and export.

Fortunately, our expansion appears to be part of a global expansion, so it’s less likely to be derailed from abroad. Japan finally sees some light at the end of the tunnel and China—the new Japan—appears to be on an unstoppable roll. China could use some additional transparency, but much progress has been made. Sooner or later, however, there may be consequences of economic freedom getting ahead of political freedom. I’m not sure it was totally a coincidence that Adam Smith published *Wealth of Nations* the same year that Thomas Jefferson wrote the

Declaration of Independence.

The growing importance of China in the world economy is exemplified by the fact that a year or two ago China was cited as a big black deflationary hole, while more recently it's been blamed for exporting inflationary pressures. It is the big elephant in the living room, but a growing, prospering China is good for the U.S. economy, not bad. We should never forget that voluntary trade is a positive sum game.

Europe seems to be doing better economically, but what it greatly needs are economic reforms—especially labor market reforms—to give them good job growth. Our productivity advantage over Europe is usually exaggerated. Much of our better performance results from the fact that we work longer hours than they do. Some of that is their voluntary choice of more leisure over more goods, but some is their extra unemployment that comes from a dysfunctional labor market. Their policymakers know what should be done, but their voting citizens are reluctant to go along.

I don't know how the dollar will fare against the euro in the foreseeable future, but I'm not much concerned about it since both we and they are keeping the float clean and allowing the market to work. The market is smarter than I am.

With that, I'll stop and put myself at your mercy.