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# Speeches by Richard W. Fisher

## Sydney, Australia | November 14, 2007

The U.S. Economy, Globalization and Inflation Measurement  
(With Brief References to Brawls, Beer and Bikinis)  
Remarks before the Australian Business Economists

There is a map in the library of our home in Texas charting the sea-lanes that my ancestors and those of my wife took to the United States. Nancy is a direct descendant on her father's side of John Knox; her brother is named Michael Collins; her mother's ancestors are listed in the Domesday Book. It comes as no surprise that her Scotch/Irish/English family sailed directly across the Atlantic to America.

My family sailed through different waters. My ancestors had a penchant for migrating first to the antipodes of the Southern Hemisphere. My mother's parents sailed from Norway to South Africa to whale and to mine in the late 1800s and never went home. My father's ancestors came here to Australia from a far different place on the English landscape than the one occupied by Nancy's.

We do not know when the Fishers came to Australia. Nor do we know if they came of their own free will. We do know that my father, Leslie, was born in Toowoomba in 1904, was abandoned by his mother and was poorly kept by his luckless father. In January of 1910, at the age of 6, he was picked up sleeping on the doorstep of a bakery while his father was off begging for food. Thus began an exotic "walkabout" that ended happily in America.

In 1999, when I was negotiating the first stages of the U.S.–Australia Bilateral Trade Agreement as an ambassador and trade representative of the U.S. government, Canberra gave me what could be gathered of my father's files. They include a letter from the director of the State Children's Department of Queensland to the officer in charge of the Toowoomba police, dated April 4, 1913. It reads as follows: "Leslie Fisher (was placed) under State control as a neglected child to our care by the Police Magistrate ... in January 1910. [His] father had no place of abode and was living from hand to mouth." It goes on to inquire of the police whether Leslie Fisher, my father, "has a home of his own, or is he living with any person in the locality?" My dad was then 9 years old.

To our knowledge, the director never got an answer back. My father had disappeared, first into an orphanage, then to a series of rather harsh foster homes, then to the streets, where he, too, survived from hand to mouth as a street urchin until 1921, when at age 17 he was taken in as an "apprentice mechanic" at the firm of Foster and Dutton.

He swept the floors and worked a lathe, earning barely enough for food and clothing. At night, he slept on the factory floor. Shortly before he died at the age of 90—he was a tough old buzzard who kept all his marbles until he drew his last breath—he told me about the afternoon he accompanied his employer to a meeting in a hotel in Brisbane. Mr. Dutton ordered tea and tipped the waiter more than he paid my father in a month. It was then and there, my father told me, that he decided he would make something of himself, but that first he had to escape his past.

In February of 1924, at age 20, he sailed for South Africa—we don't know if he somehow paid his passage or simply stowed away—where he found work as a bus driver in Jo'Berg and eventually found my mother. Once they had saved enough, they sailed for America and the golden shores of California in 1939.

But America would not immediately have him. The United States was willing to admit my mother but not my dad. And so they shuttled between Los Angeles and Tijuana, a few hundred miles south just over the border on the Mexican side. Dad did what he needed to make a living, selling cars in California and beating the bookies at the then-famous Tijuana Race Track—a skill he no doubt honed as a street gambler and "two-up" champion back in Queensland. The U.S. authorities admitted him and my mother to U.S. citizenship in 1947.

The story gets richer still. In 1948, on the eve of the Red Army's entry into Shanghai, my father was hired to sail to that city to "collect" a payment a Chinese company owed a firm called Spazier Chemical and Soap. My mother and two brothers went with him. After a bit of time and effort, he succeeded in collecting the money, and they sailed out on the *S.S. President Wilson* back to Los Angeles. It was one of the last ships to leave Shanghai before China's troops closed down all passage. They brought back more than what was due Spazier Chemical: They brought me. I was born eight months after the *Wilson* left China.

Incidentally, 50 years later, when I was helping negotiate the U.S. side of the deal to bring China into the World Trade Organization, Madam Wu Yi, who oversaw China's team, told me I must have gotten my luck in life from being "Made in China."

Soon after I was born, we moved to Mexico City, where I received my primary school education, and from there began the serendipitous life that was more than generously summarized by Tony Richards in that kind introduction.

Although he led a rough life here, my father taught us to be proud of our Aussie heritage. He said he was just an example of the tenacity of Australians. "They are the best brawlers and fighters in the world," he would say. And, for puckish good measure, he would add, "and they love beer and bikinis."

I am the product of an Australian walkabout of epic proportion, a testimony to the fact that Australians are the hardiest of peoples. I understand you have heard from some of my Fed colleagues via satellite, but I am very proud, as a son of an archetypically hardy Australian, to be the first representative of the Federal Open Market Committee (the FOMC) of the U.S. Federal Reserve System to address the Australian Business Economists in person. Thank you, Robert [Henderson], for inviting me here.

I have recited this long and bizarre history not just out of familial pride, but because I know some among you feel the U.S. is a bit closed-minded about globalization and tends to think

myopically—either because we are so bloody large or by virtue of having been a pretty-much self-contained economic powerhouse for so long. I was "assembled" in China from English/Australian and Norwegian/South African parts, was "programmed" in Mexico and realized my "value added" in the United States. You can't get much more globalized than that!

Many of the governors and fellow bank presidents I serve with on the FOMC may have less complicated backgrounds, but they also get the picture: The economy in which we set monetary policy is entirely different from that of our FOMC forbearers, placing new demands on our skill sets.

I will focus my comments tonight on the current state of the U.S. economy. Having just invoked my colleagues, I should mention, as I always do, that my comments this evening are in no way the official position of the U.S. Federal Reserve or the FOMC. They are my views, and mine alone.

## **Recent Developments in the U.S. Credit Markets**

You are all well aware of the events that began to rattle the credit markets in August. Indeed, the media and analyst coverage of the market turbulence has been so extensive that you would have had to have gotten lost on the walking tour around Ayers Rock last July and just now found your way back to civilization to be unaware of subprime mortgages, collateralized debt obligations (CDOs), structured investment vehicles (SIVs) and the write-downs taken by several leading financial institutions. The disruptions to the orderly functioning of the financial markets have been significant, and the Fed and other central banks around the world have acted to keep those markets functioning. Beyond the troubles in financial markets, we have had an otherwise healthy economy in the U.S., with, thus far, the only other significant signs of weakening coming from continual corrections in the housing market.

The Federal Reserve took action in mid-August, first lowering the discount rate by a half percentage point at a specially convened session of the FOMC, making clear we, like all learned central bankers, had read Walter Bagehot. Then, at our regular September meeting, we cut the federal funds rate by a half percentage point and the discount rate by the same amount. By the time we met again on October 30 and 31, the hardening of the arteries or the blocking of the aorta, or whatever cardiovascular analogy you choose to describe what was afflicting the circulatory system of the credit markets, was no longer as severe and life threatening as it was in August. Indeed, investors had begun moving toward marking financial assets and exposures to market—pricing them according to what they might actually be bought or sold for—rather than at values posited by hypothetical mathematical models.

A startling statement appeared in the *Financial Times* on October 26: A particularly astute market operator commented that "corporate treasurers are no longer investing in things they don't understand." Imagine that! Investors are coming home from la la land. To be sure, they are not out of the woods quite yet, and they have miles to go before they, and we as central bankers, sleep. But they have gone beyond suspended reality. You might say the credit markets have gone from the ridiculous to the subprime; the subprime and related derivatives market is the focus of angst, but the ridiculous practice of the suspension of reason in valuing all asset classes appears to be in remission, if not over.

We have a way to go before full recovery and must acknowledge that shocks and accidents might happen. Phrasing it politely, as an Aussie-Texan, I suspect some real "cow patties" remain in some prominent institutional punchbowls in the U.S. and abroad, and they will undoubtedly come to light before too long. I would submit, however, that we are on our way back to markets priced by reason rather than fantasy and that systemic risk has been lessened substantially.

While the Federal Reserve remains ready to act if needed—as we have hopefully made clear by our actions and statements—I believe it was appropriate for the FOMC to focus squarely on the economy at its October 30 and 31 meeting.

## **The Outlook for the U.S. Economy**

At 11 o'clock tomorrow morning Dallas time, the U.S. economy will officially be entering its seventh year of expansion. Here is how I view our economic situation from my perch at the Dallas Fed. To begin, one has to take account of the corrections from a long period of excessive inflation of the U.S. housing stock. The sharp turnaround in mortgage availability will influence consumer spending by affecting both the amount of household wealth and the ability of homeowners to tap that wealth. Because mortgage availability has changed so much so quickly, the precise effect of this change is hard to gauge and is thus worrisome. Yet, it may also be subject to overstatement, given the Fed's response. The overstatement may also be partly due to the news media's penchant for "instant analysis"—my favorite oxymoron, akin to jumbo shrimp or nonalcoholic beer—which tends to focus on the downside. The flexibility and recuperative power of our extraordinarily adaptive economy creates a dynamic often overlooked by pessimistic pundits and even some thoughtful economists. My soundings find no appreciable, let alone debilitating, signs of spillover into the rest of the economy as yet. To be sure, the economy has been weakened, but it has not shown signs of succumbing to the full-blown virus infecting housing.

Going back to January, and even more so since the spring, banks in my district and elsewhere have reported tightening terms and standards on loans to businesses and households, and the overall mood of the country as reported by the press is sour. Yet, we haven't seen sharp increases in initial jobless claims, dangerously low Purchasing Managers Index readings or persistent declines in durable goods orders. The service sector—which people too often forget accounts for 83 percent of the U.S. economy versus 11 percent for manufacturing, 5 percent for construction and mining, and 2 percent for agriculture—remains strong and productive. Indeed, economic growth was robust enough in the first estimate of third quarter growth to ring in at 3.9 percent. In an economy the size of the U.S., that means we added over \$150 billion in output from July through September—a lot of new economic activity. What we added to GDP in just one three-month period exceeds the total annual output of your neighbor New Zealand by 50 percent!

Households are still reasonably optimistic, although perhaps a bit more cautious, about their job prospects, and consumer spending continues to grow at a decent clip. There remain widespread reports of labor shortages all across the country. Texas, where over 247,000 net new jobs have been created year to date, representing between 15 and 20 percent of the jobs created in the entire U.S. this year.

The bottom line? A fat left tail where some risk of substandard growth is clearly on the growth probability curve, but the more likely outcome is for the U.S. economy to continue to expand at a sustainable pace.

In part, this is due to service sector strength, infrastructure and durable goods spending that is running better than expected, fiscal stimulus and strong export performance. U.S. overseas sales have been propelled by increasing demand and facilitated by a progressively weaker dollar. We meet tonight as the trade-weighted dollar skates along a post-Bretton Woods low—not an easy thing for a strong-dollar man to note.

Certainly, some risk remains that downward momentum will emerge. Personally, I worry about the plight of big population states like Florida and California, where the housing correction is having its severest impact. I note the reports issued by express shippers and ground transportation firms that show deceleration in year-over-year trends in pre-holiday traffic across the nation. I realize that Wal-Mart and other large retailers have seen a slowing in same-store sales growth, that shopping mall traffic is down, and that the restaurant business—a not-insignificant part of the service sector that employs 14 million Americans—is showing signs of strain as customers migrate from casual dining to more affordable fast-food providers. And, if you parse the data for the third quarter, you will see a pretty stout guesstimate of inventory accumulation. These are prototypical signs of an economy in stress.

Yet, before each FOMC meeting, I consult 35 CEOs from a broad range of businesses, and with the exception of homebuilders, not a single one of them feels the economy is at risk of falling off the table. Big builders and engineering firms report a booming domestic infrastructure business, especially in the petrochemical sector from the Gulf Coast up through the lower Midwest. The tech folks continue to find demand brisk—as manifest in earnings reports of Microsoft, Apple and others.

One of the biggest providers of computer services to businesses reports that, with the exception of financial institutions, sales have begun to flow again after being laid low by the uncertainty of August. The airlines report recent volume has been "less bad" than it was in the third quarter. Shippers and railroads are concerned about consumer holiday demand and note slowing trans-Pacific shipments into the U.S. Yet, they report that the tech product side of what they move looks good, so the net impact, while nowhere near robust, is that conditions have not materially worsened. Outside of housing and payments due to some major law firms, we are not seeing a significant lagging of receivables. The mention of law firms may have caught your ear. They have grown quite important to the U.S. economy. Nearly one million people work in legal services in America, roughly the same number who work in manufacturing automobiles and auto parts.

## **Inflation**

As they survey the economic landscape, many of my business interlocutors, however, worry about prices. As do my staff and I. We have been experiencing a mitigation of inflationary forces and expectations recently, whether measured by such headline numbers as the Consumer Price Index (CPI) or the index of Personal Consumption Expenditures (PCE) or the so-called core indexes that exclude energy and food prices. And we have seen it in the trimmed mean measurement preferred by the Dallas Fed.

Yet, there appears to be some uncertainty about whether we will continue to see inflation slowing. Partly this stems from retailers who report cost increases on goods imported from China or from shippers who see continuous upward pressure on lease rates to move more expensive imports across the seas. We are also hearing it in other anecdotal reports, such as the rise, nationwide, of salaries paid to attorneys, architects and other highly skilled professionals.

Our concern about inflation at the Dallas Fed stems from two more pervasive sources—food and energy, where we foresee a risk of a more pernicious pass-through effect than we saw in the recent price increases of underlying commodities.

In food markets, we have seen a dramatic divergence this past year between food prices and the core measures that indicate inflation in the 2 percent range. The CPI shows food up 5 percent through September. Green grocery prices are rising at a double-digit pace. The Producer Price Index for finished consumer foods, or wholesale food prices, is up 4.3 percent year to date. This pattern has historical precedent. A spread of the current magnitude between food price inflation and the core index occurred on several occasions between 1957 and 1980. But we have not seen it in a quarter century.

As Australians, you know better than anyone about the dramatic increase in milk prices, to say nothing of grains and other foodstuffs that go into feeding any creature that walks on two or four legs. This is hardly encouraging, given that these price increases are occurring against a ramping up of the caloric and protein intake of a few billion new eaters in China, India and elsewhere. All told, it injects a modicum of doubt about the wisdom of predicting further significant declines in inflationary pressures.

Energy price dynamics further cloud the picture. If you talk to any of the major and independent oil companies, they will tell you they have no problem in finding oil or refining it or delivering final products. They will note, however, two key impulses that are at work:

First, they see no evident slowing in the growth of demand for energy in the U.S. The energy appetite in the BRICs—the big, fast-growing nations of Brazil, Russia, India and China—is voracious, and they are only part of the developing world. An enormous amount of chemical plant infrastructure and capacity is being constructed everywhere—from the U.S. Gulf Coast to the Middle East to China and Singapore—to be nearer to either feedstocks or growing final demand. Any analysis of the income elasticity of oil demand in low-income but rapidly growing nations like China and India points to even faster rises in energy consumption, with concomitant price consequences.

Second, price pressures at the margin are compounded by noncommercial activity in the markets that trade oil. Noncommercial contracts—the busywork of the "city refiners" in the financial exchanges in London and other places—have been running at triple their traditional volume lately.

Prices for gasoline and distillates—where the pass-through rubber hits the consumer price road—are starting to inch up in response. Our retail gasoline price models at the Dallas Fed envision pump prices above \$3 a gallon for the foreseeable future if crude stays above \$85. Price pressures for other distillates are also becoming increasingly probable. And last, high inventories continue for natural gas, but it is noteworthy that prices have reversed their

summer slide downward to \$5.50 per million BTU and are now quoted at \$7.15 at the Henry Hub in Louisiana, the key metric point for the U.S.

All this gives me a sense of discomfort on the headline inflation front, and it is a reminder that the balance of risks is not skewed unilaterally toward slower growth. This is not to say I expect inflation to veer out of control. But rather, it means that we must remain far from smug on the inflation front and must conduct monetary policy bearing in mind that the battle against the nemesis of inflation is a perpetual effort.

This vigilance has always been second nature for the subgenus of the human species known as central bankers. Like the Reserve Bank of Australia, the Federal Reserve and the FOMC rely on an impressive array of instruments in determining monetary policy that contains inflation so as to enable sustainable economic growth. We are blessed with a rich complement of superb economists and a fulsome dashboard of databases. But in the end, no models or formulas substitute for judgment in making monetary policy.

Our job has been made more complicated by globalization—the freer flow of goods, services, money, ideas and people across national borders. Its present incarnation owes a great deal to the revolution in information technology. Faster, cheaper and better communications are breaking down barriers to international business and knitting the world's economies closer together faster than Skippy could outsmart a pack of hungry dingoes.

Consider how this affects employment, which under our dual mandate the Fed is duty-bound to maximize without upsetting price stability. Computers, the Internet and fiber optics have opened new horizons for virtual immigration, which allows companies to assign tasks to workers nearly anywhere in the world. We can now tap into the intelligence on the ground in Slovakia or Mumbai as easily as you do in Sydney or Melbourne. Communications technology gives us the tools to get around—at least partly—the restraints imposed by physical location. It allows businesswomen and men to better manage their cost of goods and services sold, as well as their cost of capital, and to sell to a larger market, in their never-ending search to expand profit margins. That is the good news. The not-so-good news is that demand-pull and cost-push pressures abroad are transmitted more readily and ubiquitously to us at home.

For central bankers, this creates a challenge. We have yet to develop the tool kit we need to understand a technology-driven, seamless, globalized economy well enough to craft monetary policy with the precision we would like. In our eclectic community, we have been debating how monetary policy is affected by globalization, technological and communication innovations, and the implications of the economic evolution into a services-driven, knowledge-based economy. How do we as policymakers, attempting to influence the course of our respective economies, navigate the economic seas when these new forces are acting like a magnet beside our traditional compass, rendering us unsure as to how far off course we may be veering? Globalization is, in my view, particularly vexing as we seek the true north of inflation control.

If we are guided by core inflation, we run certain risks. Core inflation refers to prices measured through statistical procedures that systematically strip out certain items from the basket of consumer prices—in the U.S., usually food and energy. By ignoring items whose price movements display significant short-run volatility, so the argument goes, statisticians

and policymakers can get a better sense of underlying trends in consumer price inflation. The goal is to strip out the noise so that we can focus on the underlying signal.

In principle, the concept of core inflation is sound. Because underlying price trends change only gradually, we will get a better sense of where overall inflation will be tomorrow if we look at measures that help us assess current trends, rather than at the recent behavior of headline inflation that includes all items, including volatile ones that skew the results.

In addition, the prices of most things are "sticky;" that is, they don't change minute by minute or day by day depending on market conditions. Some models now in vogue suggest that central banks should focus their attention on stabilizing an index of the stickier prices in the economy. Food and energy prices are manifestly not sticky in our economy and, so the theory goes, should not be the focus of our attention.

Central banks have good reasons to subtract volatile swings in prices, but routinely excluding food and energy—and only food and energy—is not, in my opinion, the best we can do. For one thing, not all food and energy prices are excessively volatile. Menu prices at restaurants, for example, are sticky, making information about their underlying trends quite valuable. Yet, a Big Mac is excluded from the usual core measurements, even though consumers eat millions of them every day. At the same time, other prices can be extremely volatile. Prices of infants' clothing, for example, are at least as volatile as most food and energy items, but they are included in standard "ex food and energy" versions of the CPI and PCE.

A more discriminating approach might be to exclude the items with the most extreme price changes in a given period, regardless of whether those items are food, energy or anything else. This is the rationale behind trimmed mean measures of core inflation that guide our thinking. At the Dallas Fed, our measure excludes, or trims out, the extreme highs and lows of price changes each month for the PCE. A trimmed mean measure is also used by the Reserve Bank of Australia.

The concept behind core inflation measures—seeking to eliminate noise and focus on signal—by disregarding food and energy prices altogether may be a sound practice in a relatively closed world with a predictable sense of the number of consumers and consumer patterns. This is what we had for a couple of generations during the Cold War era, led by an ultra-dominant U.S. economy; eliminating food and energy to silence a significant source of noise made sense in this structure.

However, a tectonic shift has occurred. Globalization, rapid acceleration of technological innovation and a series of key geopolitical events have created an open economy infinitely more complex and decidedly more unpredictable. The world economy now incorporates China, India and the former captives of Soviet and Southeast Asian communism, and their caloric and BTU intake patterns are converging toward ours as they grow richer. Three billion people have entered the world's market, and they are ready to work, ready to innovate and ready to shop. As a result, we are undergoing a sustained period of fundamental economic change that is forcing us to reexamine energy and food price movements through different lenses.

When we pay more for food and energy, it may no longer represent mere noise but might be providing signals of longer-term, structural inflationary pressures.

In these circumstances, a trimmed mean approach has merit. A trimmed mean approach will still trim out volatile noisy numbers, which might include food or energy in any given measurement period. But it will retain, and thus allow us to focus on, the signals sent to help determine the true course of inflation.

Now, before you rush out from dinner saying that Richard Fisher weighed in against Mr. [Peter] Costello on behalf of the Reserve Bank, let me point out that trimmed means—while better than the standard ex-food, ex-energy core measurements—are imperfect things. A few items that have important implications for our living standards—computers being the prime example—experience large, technology-driven price declines month in and month out and hence get trimmed out. The Dallas Fed tries to correct for this potential source of bias through our choice of trimming proportions, but we realize that correction is imperfect.

An additional drawback is that while the theoretical virtues of trimmed mean measures may appeal to central bank aficionados and econometricians, they may fail to resonate with the people we serve. Humans—real people like my father and others who appreciate brawls, beer and bikinis—experience inflation and develop inflationary expectations based on what they see and experience in the marketplace and read in the papers. To people who drive to work, air-condition their home and eat, ex-food, ex-energy measures or trimming this or that out of a price index is nonsense. Central bankers must be attentive to this sensitivity if they are to maintain the public's confidence.

In formulating and making my arguments at the FOMC table about the direction of inflation, I draw on all three measures—the headline, the core and the trimmed mean number—in making my recommendations on monetary policy. I also draw on an intrinsic admiration for the dynamism and constant inventiveness of a society that can transform the poor and the luckless, like my own family, into middle-class prosperity, time and time again. And presently, viewing the U.S. economy through the lens of globalization, I find that there is greater symmetry of risk between growth and inflation than is commonly surmised.

I will stop here and, in time-honored central banking fashion, now do my best to avoid answering your questions.

Thank you.

#### **About the Author**

Richard W. Fisher is president and CEO of the Federal Reserve Bank of Dallas.

The views expressed by the author do not necessarily reflect official positions of the Federal Reserve System.