

Richard W Fisher: An economic overview – what’s next? Remembering Carol Reed, Aesop’s Fable, Kenneth Arrow and Thomas Dewey

Remarks by Mr Richard W Fisher, President and Chief Executive Officer of the Federal Reserve Bank of Dallas, before the Rotary Club of Dallas, Dallas, Texas, 13 July 2011.

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

Thank you, Jim [Struble], for that kind introduction.

It is always a pleasure to speak to Rotarians. Until I went to Washington in 1997 to serve as the deputy U.S. trade representative, I was a member of this wonderful downtown club. I especially loved the patriotism and the esprit de corps that characterize every meeting. I have always considered Rotarians the Marine Corps of the civic community. Remember what Ronald Reagan said about the Marines? “Some people spend an entire lifetime wondering if they have made a difference. The Marines don’t have that problem.” Neither do Rotarians.

Nor do they have a problem injecting a little humor to lighten the load of the day. When I was a member of this great club, Carol Reed used to read the “news” at the beginning of every meeting, picking subjects not ordinarily reported in the traditional media. One of her most memorable reports was about a man who had fallen into a river in Egypt and had allegedly managed to fight off an attack by a 14-foot crocodile. The punch line, of course, was that if you didn’t believe a man could fend off a croc with his bare hands, then you yourself were in “de-Nile.”

We are no longer in denial about our national economic plight. Our great country now finds itself in a very difficult predicament. It is true that the situation here in Texas is relatively better than that of the nation; Texas is an oasis in a national economic desert devoid of life-giving job creation. We went into the Great Recession last and were one of the first to come out. As we have for the past 20 years, we continue to outpace the rest of the United States in employment growth by a significant margin. Since the Great Recession officially ended in June 2009, only North Dakota (a plucky state whose hearty population totals less than that of Collin or Denton counties) has seen faster job growth than Texas.¹ As I speak, Texas has almost as many people employed as we did before the recession began. Our banks are in better shape than those in the rest of the country; we are benefiting from the blessings of nature, with copious amounts of oil and gas and abundant agricultural production; our fellow citizens have seen to it that our Legislature continues to hew to a tax, regulatory and legal environment that attracts job-creating investment and encourages business formation and growth. And yet, even in this blessed state, there are too many unemployed and underemployed, just as there are in the rest of America. We can do better. America must do better.

The question is: How?

To create employment, we must have economic growth.

The simplest of econometric equations posits that the key components of economic growth are domestic consumption, plus foreign demand for U.S.-produced exports, plus investment by businesses, plus spending by government.

I think it is pretty clear to everyone who lives on the planet that in order to grow our economy and put our people back to work, we must rely on our ability to curry to domestic and foreign

¹ The Great Recession’s end date was established by the National Bureau of Economic Research, which officially declares the beginning and end of recessions.

consumption and invest here at home to produce the goods and services to sell in the marketplace. You'd have to be from Mars to believe that the federal and state governments will be the source of much direct spending stimulus to the economy.

Presently, all eyes are focused on the budget negotiations in Washington as the debt-ceiling clock ticks on. Aesop's classic fable comes to mind. Rather than work like ants to build and store for difficult times, our fiscal authorities – Congress after Congress, under Republican and Democrat leadership alike, and with presidents of both parties occupying the White House – have been proverbial grasshoppers. Except for a few interludes, they have partied along for decades using the people's money as though life were an endless summer, storing nothing to draw upon for the blustery fall and the bleak winter that inevitably follow. Now a fiscal reckoning is upon us. The gig is up. Congress can no longer carry on as before, oblivious to the deleterious effect of spending our, and the successor generations', money with unfunded abandon.

Tongue firmly in cheek, Carol Reed might have reminded us that there are alternative versions of this fable. In 1924, Somerset Maugham wrote a version about two brothers: one an ant-like hard worker and the other a grasshopper wastrel. In the end, the grasshopper marries a rich widow who dies and leaves him a fortune.² Case closed! In *Things Change*, a film released by Columbia Pictures in 1988, the character played by Don Ameche recites a version in which the grasshopper, fed up with all this moralizing about the virtues of hard work and saving for a rainy day, just up and eats the ant.

I think we can safely assume that neither of these scenarios will occur. No one is going to bail out the government at the last minute. The ants that are the hard-working taxpayers are, if anything, poised to chew up and spit out improvident politicians should they fail to put an end to fiscal profligacy. The fiscal authorities have no choice but to come to terms with the need to bring about a better balance between taxes and spending and to not only bend the curve, but reverse the inexorable growth in federal debt accumulation. This is the stuff of the great negotiations taking place among the executive branch and the two houses of Congress.

This is no small chore. The parties involved must stop the hemorrhaging without inducing cardiac arrest; they must solve the long-run debt and deficit problem without, in the short run, pushing the economy back into recession, creating still more unemployment. And they must not only confront their addiction to debt and spending beyond their means, but they must reorganize the tax system, redirect the money they collect and rewrite the regulations they create so as to be competitive in a world that wants to beat us at our own game.

This is an essential point. It will not be enough to reach a deal on the debt ceiling or on partially reining in deficits. In the post-Cold War, post-Bamboo Curtain world, there are many governments and great swathes of people outside the United States that want to attract investment and improve their lot. We are being challenged as the place to invest job-creating capital. Our fiscal and regulatory authorities do not operate in a vacuum; we live in a globalized, interconnected world where money is free to go to wherever it earns the best return. In their solution to the debt crisis, our political leaders must develop an entirely new structure of incentives for private businesses and investors to put their money to work creating jobs here at home.

Only fiscal authorities have the power to affect this outcome. Monetary authorities, like me and my colleagues on the Federal Open Market Committee of the Federal Reserve (FOMC), have limited influence. We can fill the gas tank with attractively priced fuel – abundant and cheap money – needed to propel the economy forward. But we cannot trigger the impulse to step on the pedal and engage the transmission mechanism of job-creating investment by the

² See *Collected Short Stories*, by William Somerset Maugham, New York: Penguin Books, 1972.

private sector. This is the province of those who write our laws and regulations – the Congress of the United States.

I firmly believe that the Federal Reserve has already pressed the limits of monetary policy. So-called QE2, to my way of thinking, was of doubtful efficacy, which is why I did not support it to begin with. But even if you believe the costs of QE2 were worth its purported benefits, you would be hard pressed to now say that still more liquidity, or more fuel, is called for given the more than \$1.5 trillion in excess bank reserves and the substantial liquid holdings above the normal working capital needs of corporate businesses. Even surveys of small businesses – most recently, the U.S. Chamber of Commerce’s survey of companies with less than \$25 million in sales and fewer than 500 employees – indicate that fewer than 10 percent of small enterprises (which employ half of the private sector’s workers) are having problems accessing credit.³ The National Federation of Independent Business specifically noted just yesterday that “91 percent [of those surveyed in June] reported that all their credit needs were met or that they were not interested in borrowing.”⁴

U.S. banks and businesses are awash in liquidity. Adding more is not the answer to our problems.

With monetary policy having reached the limits of accommodation, and the federal government at sixes and sevens, what then is the foreseeable economic outlook? Are we going to grow through the rest of the year and on into the next, or are we going to dip back into recession?

Forecasting economic growth is not a precise business. Economics is an art form, not a science; it is very judgmental and subjective. The FOMC is composed of 17 thoughtful, introspective and deliberate men and women. Five of the members serve full time in Washington as Governors of the Federal Reserve Board, appointed by presidents of the United States with the approval of Congress. The remaining 12, like me, are chosen by nine-member, nonpolitical boards of directors of citizens in their districts and charged with conducting the business of the Fed in the field based on our business acumen and with developing policy insights based upon what we see, hear and measure on Main Street. Together, the 17 of us formulate policy with the best judgment we can collectively muster, free from political pressures or the passions of the moment, on what is in the best long-term interest of the country’s economy.

We each gin up forecasts for the economy. All 17 FOMC participants’ expectations for the economy through 2013 and beyond were released to the public yesterday and widely reported in the press today.⁵ To develop those forecasts, we employ sophisticated econometric models, study the entrails of numerous comprehensive surveys conducted all across the nation – like the Dallas Fed’s Texas Manufacturing Outlook Survey and the Texas Retail Outlook Survey and their counterparts in other Federal Reserve districts – and draw upon input from our boards of directors, numerous advisory boards and contacts with businesses and stakeholders nationwide and worldwide. These forecasts are helpful guideposts, but they must be kept in context.

Kenneth Arrow, one of the most notable Nobel Laureates in economics, has his own perspective on forecasting. During World War II, he served as a weather officer in the U.S. Army Air Corps and worked with a team charged with the particularly difficult task of producing month-ahead weather forecasts. As Arrow and his team reviewed these

³ See “Little Hiring Seen by Small Business,” by Siobhan Hughes, *Wall Street Journal*, July 11, 2011

⁴ See Small Business Economic Trends survey, National Federation of Independent Business, www.nfib.com/research-foundation/surveys/small-business-economic-trends.

⁵ See the Federal Open Market Committee meeting calendar, www.federalreserve.gov/monetarypolicy/fomccalendars.htm.

predictions, they confirmed statistically what you and I might just as easily have guessed: The Corps' weather forecasts were no more useful than random rolls of a die. Understandably, the forecasters asked to be relieved of this seemingly futile duty. Arrow's recollection of his superiors' response was priceless: "The commanding general is well aware that the forecasts are no good. However, he needs them for planning purposes."⁶

Keep Ken Arrow in mind when you hear economists tout precise forecasts carried out several places to the right of the decimal point. You may need economists' forecasts for planning purposes, but you should always take them with a grain of salt, even when the time horizon is a short one. I will direct you to an article in the Feb. 14 *Wall Street Journal* as evidence. The *Journal* had polled 51 leading economists, and they forecast that gross domestic product (GDP) would expand 3.6 percent in that very same first quarter.⁷ Growth came in at 1.9 percent.

When economists forecast we will have growth of, say 3.6 percent, remember they are saying .036. It is an elaborate conceit to think anybody can be that precise in an economy as large as that of the United States, operating as it does within the context of an even larger, very dynamic, global economy. This is true for Fed economists as well as academics and those who sell their forecasts for a living.

This is not to say that we will cease and desist from making "point" forecasts. But what matters most to me is the direction in which the numbers are headed and the general sense of momentum. At this juncture, I think it sufficient to say that, assuming the people we elect to tax us and spend our money and create the rules and regulations that govern our economic behavior can at long last get their act together, confront their own denial of most rudimentary budgetary discipline, learn to shoot straight and remove the Damocles Sword of uncertainty that they have for too long unwittingly wielded over our job-creating private sector, there is plenty of potential for the economy to move forward at an accelerating clip. This is especially the case now that the Fed has relinquished the economy.

I expect that economic activity will accelerate in the second half of this year, with real GDP likely to rise at an average annual rate of between 3 and 4 percent. Lest you get carried away with excitement, I must note that some of the acceleration in activity will be a function of inventory adjustment, and much will stem from an unwinding of the disruption caused by the Japanese earthquake and tsunami as the Japanese make up for supply interruptions to the auto and other industries faster than many thought possible. Looking beyond 2011, I hope that growth above 3 percent can be sustained, again assuming the fiscal authorities get it right.

As Jim has referenced, I may have called the bottom of the recession in the summer of 2009 well before most anybody else did, but I made the point in that *Dallas Morning News* interview that going forward, we were going to have a slow slog.⁸ I have said many times since then that, in light of the fact that we were recovering from "post-traumatic shock syndrome" stemming from the Panic of 2008 and 2009, economic recovery would proceed hesitantly, taking two steps forward and one step back until it finds its new legs. We took a step backward in the first half; I expect we will proceed forward, however haltingly, in the second half and into 2012.

⁶ *Eminent Economists: Their Life Philosophies*, ed. Michael Szenberg, Cambridge, England: Cambridge University Press, 1992.

⁷ "Consumer and Business Spending to Spur Expanding U.S. Economy," by Phil Izzo and Justin Lahart, *Wall Street Journal*, Feb. 14, 2011.

⁸ "Recession Over, Dallas Fed Chief Says, but Jobs Lag," by Brendan Case, *Dallas Morning News*, Aug. 26, 2009.

The point is that I do not think we need be stuck in the low gear of the first half. Some of the temporary influences that I believe retarded growth in the first half – high gasoline and unprocessed-food prices, the supply disruptions in Japan, etc. – are passing through the system and are either being reversed or digested. To be sure, some businesses are being hit with higher input costs from imported goods and other nonlabor cost increases. Having become as lean as possible and having learned to preserve their margins by years of tight cost management and by maximizing productivity, they don't have much fat to absorb the cost of input increases. If input price increases continue or spread, these businesses will naturally attempt to pass them on to consumers, who are wary of anything else that will compress their living standards.

I see a bit of a tug-of-war developing here. The issue will be whether businesses can exercise pricing power in the face of fallow consumer demand. As an inflation "hawk" – I prefer to think of myself and my 16 colleagues, hawks and doves alike, as wise owls – I am watching this very carefully. If I see inflation continuing to rise and, most importantly, inflationary expectations beginning to spread, I will be the first out of the box to advocate the removal of the substantial monetary accommodation now in place. I cannot think of anything more damaging to the welfare of hard-working Americans who have jobs, those who are unemployed and barely eking out a living, retirees who are earning minimum returns on their savings, or any consumer already stretched thin, than to have their purchasing power reduced by still higher inflation.

Yet even though I am a central banker and am professionally disposed to being a worrywart, I am more optimistic about the economic outlook than the consensus. American businesses and workers have made very important improvements in their efficiency and competitiveness that will aid growth. If we can add to that a sound long-run budget deal, the recovery could gain even more strength. We are a resilient people. I know it is fashionable to think we have somehow been infected with an economic stasis with no way out, but as a Texan and an American, I am culturally unable to accept that view.

During the Q&A that followed a recent speech of mine abroad – in New York – a questioner cited the sickly economic pace of the first quarter and then recited the consensus view that very weak growth will likely ensue for the rest of the year and beyond. In response, I cautioned that forecasting based on current trends can be very misleading. And the consensus view – usually conveyed with confidence all the way out to three places to the right of the decimal point – is almost always wrong, even within short time periods.

I asked my interlocutor to recall the presidential election of 1948. The consensus view called for a landslide victory by Gov. Dewey. Indeed, an early edition of the ***Chicago Daily Tribune*** on the very night of the election announced in the boldest of headlines that Dewey had won. Before going to sleep, an overconfident Dewey is reported to have turned to his wife and said, "Just think about it: Tomorrow night, you are going to be sleeping with the president of the United States!"

The next morning at breakfast, Mrs. Dewey asked, "Am I going up to Washington this evening or is Harry Truman coming to our house?"

Carol Reed would love to have reported that story!

Thank you, Rotarians. You are the embodiment of what makes this country great. Carry on with your good works.