Globalization & Policymaking

Richard W. Fisher, president of the Federal Reserve Bank of Dallas, is a keen observer of globalization.

In November 2005, Mr. Fisher delivered a speech in Cambridge, Massachusetts, on globalization and monetary policy. And in December 2005, in Philadelphia, Pennsylvania, he delivered remarks on globalization and government policy.

We share with you here major portions of both speeches, and we have provided links to the complete text for each.

Globalization and Monetary Policy

Richard W. Fisher, President, Federal Reserve Bank of Dallas
Warren and Anita Manshel Lecture in American Foreign Policy
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Complete speech:**http://www.dallasfed.org/news/speeches/fisher/fs051103.html**

The literature on globalization is large. The literature on monetary policy is vast. But literature examining the combination of the two is surprisingly small.

If you Google "globalization" and "monetary" and "policy," you will turn up more than 2 million references. However, a search of scholarly articles with the same word combination turns up only 30,700. If you narrow your quest to the exact word combination "globalization and monetary policy," you get a mere 39 citations. Limiting the word combination to the title of an article, you will find a mere two articles.

So, at a minimum, this is going to be a rare speech! I hope it will prove insightful.

Tom Friedman's popular book *The World Is Flat: A Brief History of the Twenty-First Century* doesn't have a single entry on "money," "monetary policy" or "central banking." And in Michael Woodford's influential book *Interest and Prices: Foundations of a Theory of Monetary Policy*, the word "globalization" does not appear in the index. Nor do the words "international trade" or "international finance."

What gives? Is the process of globalization disconnected from monetary policy? Is the business of the central bank totally divorced from globalization?

I think not. I believe globalization and monetary policy are intertwined in a complex narrative that is only beginning to unfold. This isn't *To the Lighthouse*. It may be that the process of globalization might never end. But I believe it does have a plot, which I will turn to momentarily.

Where does monetary policy come into play in this world? Well, consider the task of the central banker, seeking to conduct a monetary policy that will achieve maximum sustainable non-inflationary growth.

Consider, for example, the experience of former Federal Reserve

Governor Larry Meyer, articulated in his excellent little book *A Term at the Fed*. It was one of the first books I read this winter in Cambridge as I prepared for my new job. In it, you get a good sense of the lexicon of monetary policy deliberations. The language of Fedspeak is full of sacrosanct terms such as "output gap" and "capacity constraints" and "the natural rate of unemployment," known by its successor acronym, "NAIRU," the non-accelerating inflation rate of unemployment. Central bankers want GDP to run at no more than its theoretical limit, for exceeding that limit for long might stoke the fires of inflation. They do not wish to strain the economy's capacity to produce.

One key capacity factor is the labor pool. There is a shibboleth known as the Phillips curve, which posits that beyond a certain point too much employment ignites demand for greater pay, with eventual inflationary consequences for the entire economy.

Until only recently, the econometric calculations of the various capacity constraints and gaps of the U.S. economy were based on assumptions of a world that exists no more. Meyer's book is a real eye-opener because it describes in great detail the learning process of the FOMC members as the U.S. economy morphed into the new economic environment of the second half of the 1990s. At the time, economic growth was strong and accelerating. The unemployment rate was low, approaching levels unseen since the 1960s. In these circumstances, if you believed in the Phillips curve and the prevailing views of potential output growth, capacity constraints and the NAIRU, inflation was supposed to rise. That is precisely what the models used by the Federal Reserve staff were saying, as was Meyer himself, joined by nearly all the other Fed governors and presidents gathered around the FOMC table. Under the circumstances, they concluded that monetary policy needed to be tightened to head off the inevitable. They were frustrated by Chairman Greenspan's insistence that they postpone the rate hikes they were proposing, yet perplexed that inflation wasn't rising. Indeed, inflation just kept on falling.

If the advice of Meyer and other devotees of the Phillips curve, capacity constraints, output gaps and NAIRU had prevailed, the Fed would have caused the economy to seriously underperform. According to some back-of-the-envelope calculations by economists I respect, real GDP would have been lower by several hundred billion dollars. Employment gains would have been reduced by perhaps a million jobs. The costs of not getting these critical calibrations right would have been huge.

Now, how was Greenspan able to get it right when other very smart men and women did not? Well, we now recognize with 20/20 hindsight that Greenspan was the first to grasp the fact that an acceleration in productivity had begun to alter the traditional relationships among economic variables.

I want to depart briefly from this story line to tell you what I have learned by watching this remarkable man work for the short time I have had that privilege. One of the attributes that makes Greenspan unique is something my wife wishes I would do better: He is a superb listener. He understood the data and the modeling techniques of the Fed's research staff. But he was also constantly talking—and listening—to business leaders. And they were telling him what he knew from years of consulting and sitting on various boards: They were simply doing their job of seeking any and all means of earning a return for their shareholders. At the time, they were being enabled by new technologies that enhanced productivity. The Information Age had begun rewriting their operations manuals. Earnings were being leveraged by technological advances. Productivity was surging.

It is important to listen to the operators of our business economy. We have millions of experienced managers and decision makers in the private sector. This may be our greatest competitive advantage, for no other population has the length and depth of experience that U.S. business operators do. They are the source of the mighty economic machine that we call America, in which we produce some $12 trillion in economic output. And just as they did by inventing new technology—and, then, using that technology—America's business managers have taken advantage of the phenomenon of globalization. Our business managers are the nerve endings in Adam Smith's invisible hand, stretching the fingers of capitalism into every corner of comparative advantage worldwide.

Just consider what the fall of the Soviet Union, the implementation of Deng Xiaoping's "capitalist road" in China, and India's embrace of market reforms mean to a business operator. Consider labor alone. In the early '90s, the former Soviet Union released millions of hungry workers into the system. China joined the World Trade Organization at the turn of the century and injected 750 million workers into play. And now India, with over 100 million English-speaking workers among its 1 billion people, has joined the game. What does an American manager—paid to enhance returns to shareholders by growing revenues at the lowest possible costs—do? Because labor accounts for, on average, about two-thirds of the cost of producing most goods and services, a business manager will go where labor is cheapest. She will have a widget made in China or Vietnam, or a software program written in Russia or Estonia, or a center for processing calls or managing a back office set up in India.

Let me tell you of one eye-opening experience. About two years ago, I was in London on business for Kissinger McLarty. I received a call from the head of Japan's equivalent of the Business Roundtable, the Keidanren, asking me to "pop over tomorrow to give a luncheon and dinner speech." They made an offer I couldn't refuse, and I said I would be glad to do it if they could arrange the flights. They booked me on Virgin Air and arranged for a car to take me to Heathrow. At the appointed time, the car didn't show up. So I called the number I had been given. The call was answered by a woman with a frightfully British accent. When I asked, "Could you kindly tell me where my car is, ma'am?" she deftly shifted to a Southwestern American accent and said, "Now don't you worry. It is five minutes away. Ah apologize for the delay. Have a nice flight."

I said, "Well, hold on a minute. You answered this call in a British accent but once I spoke, you shifted to a Texas accent. Who are you? Where are you?"

"Well," she answered, "I am a call center operator in Bangalore."

"Have you ever been to the United States?" I asked.

"Oh, no, sir. But I can tell that you are from Arkansas, Texas or New Mexico."

"And how do you learn to speak like me?"

"Well, sir, for people like you, we watch a tele show called *Walker, Texas Ranger*."

"And what if I were from Boston?"

"Ah, for those people we watch *Cheers*."

It may seem like a small matter that a Japanese firm employed a worker in India to track a car by GPS in London and mimic a voice from Texas. But globalization impacts the conduct of business—and therefore the expansion of our productive capacity and the pricing mechanism of labor and other inputs—so much more profoundly.

Let me return home to Harvard once more and read you three quotes from Joseph Schumpeter, who taught here from 1932 until 1949, and I think you will get the picture.

First, from *Capitalism, Socialism, and Democracy*: "The fundamental impulse that sets and keeps the capitalist engine in motion comes from the new consumers' goods, the new methods of production or transportation, the new markets, the new forms of industrial organization that capitalist enterprise creates."

From that same page: "The opening up of new markets, foreign or domestic, and the organizational development from the craft shop and factory...illustrate the same process of industrial mutation...that incessantly revolutionizes the economic structure from within, incessantly destroying the old one, incessantly creating a new one. This process of creative destruction is the essential fact of capitalism. It is . . . what every capitalist concern has got to live in."

And from volume 1 of Schumpeter's *Business Cycles*: "A railroad through new country, i.e., a country not yet served by railroads, as soon as it gets into working order upsets all conditions of location, all cost calculations, all production functions within its radius of influence; and hardly any 'ways of doing things' which have been optimal before remain so afterward."

String the key operative phrases of those three citations together and you get the plot of this story, the plot of globalization: "The opening up of new markets, foreign or domestic. . . revolutionizes the economic structure, . . . destroying the old one, . . . creating a new one. . . . [It] upsets all conditions of location, all cost calculations, all production functions, . . . and hardly any ways of doing things which have been optimal before remain so afterward."

The master of creative destruction of syntax, Yogi Berra, put it more eloquently: Once you open new markets, "History just ain't what it used to be."

The destruction of communism and the creation of vast new sources of inputs and production have upset all the calculations and equations that the very best economics minds, including those of the Federal Reserve staff—and I consider them the best of all—have used as their guideposts. The old models simply do not apply to the new, real world. This is why I think so many economists have been so baffled by the length of the current business cycle and the non-inflationary prosperity we have enjoyed over the past almost two decades.

You could sense something was wrong with the econometric equations if you listened to the troops on the ground, fighting in the trenches of the marketplace. This is what Chairman Greenspan does so well. And, though I am no Greenspan and never will be, this is what my colleagues and I at the U.S. Trade Representative's office did negotiating market-opening trade rounds with China, Vietnam, Mexico, Brazil and others. It is what my colleagues and I at Kissinger McLarty did while advising dozens of U.S. companies seeking entry into China and the former Soviet satellites and India and Latin America. It is what my colleagues and I on the FOMC do by making dozens upon dozens of calls to CEOs, COOs and CFOs of businesses, large and small, every month to prepare for FOMC meetings. We are simply observing managers at work expanding the capacity of our economy, expanding the gap between what their previously limited resources would allow them to produce and what their newly expanded globalized, technologically enhanced reach now allows them to produce.

From this, I personally conclude that we need to redraw the Phillips curve and rejig the equations that inform our understanding of the maximum sustainable levels of U.S. production and growth.

Let me illustrate the point by citing another fine writer, Greg Ip. In yesterday's *Wall Street Journal*, he noted that the "U.S. economy grew at a 3.8% annual rate in the third quarter [of this year], its eighth consecutive quarter at about that pace. That's above what most economists consider the economy's potential growth rate—that is, what it can produce with existing capital and labor."

How can economists quantify with such precision what the U.S. can produce with existing labor and capital when we don't know the full extent of the global labor pool we can access? Or the totality of the financial and intellectual capital that can be drawn on to produce what we produce?

As long as we are able to hold back the devil of protectionism and keep open international capital markets and remain an open economy, how can we calculate an "output gap" without knowing the present capacity of, say, the Chinese and Indian economies? How can we fashion a Phillips curve without imputing the behavioral patterns of foreign labor pools? How can we formulate a regression analysis to capture what competition from all these new sources does to incentivize American management?

Until we are able to do so, we can only surmise what globalization does to the gearing of the U.S. economy, and we must continue driving monetary policy by qualitative assessment as we work to perfect our quantitative tool kit. At least that is my view.

Now that you have some insight into the frustrations central bankers have with how globalization impacts their deliberations, let me turn to how their actions impact globalization.

Remember my description of the job of the Fed, or any other central bank, as maintaining the cardiovascular system of the economy? A healthy cardiovascular system enables the brain and propels the muscles of production. The quantity of the money supply is critical to economic success, as is the quality. If the productive forces and employers of the world are threatened by, say, the virus of inflation due to ill-implemented monetary policy, they will be disabled from achieving maximum efficiency.

The cost of capital is a critical variable in any business operation. The lower the cost in real terms — net of inflation—the better.

Get to a Bloomberg terminal and look across the world. Interest rates have been trending downward to post–World War II lows as inflation has trended downward. Over the past few years there has been a noticeable convergence of rates all along the yield curve—from the shortest term you can borrow money to the longest. (Indeed, due to increasing confidence in the determination and ability of central banks to hold inflation at bay, the term "long" has now been stretched out to 50 years.) This is true not just for the major economies. As a proxy for what this means to business borrowers worldwide, consider some sovereign credits. Greece, backed by the euro, borrows funds of 10-year maturity at 3.7 percent. Poland can borrow 10-year money at 5.2 percent. And here is my poster child for what I consider the miracle of globalized money markets. Let me read to you from the *Financial Times* of October 28: "Vietnam yesterday raised $750 million with . . . a dollar denominated . . . 10-year bond. Investors put in orders totaling $4.5 billion, six times the amount on offer. During trading in New York . . . the bond . . . was priced to yield 7.125%." When I was at Harvard, we were killing the Vietnamese. Now we are financing them, and at low rates.

I seriously doubt that had central bankers here or elsewhere in the world not managed their affairs in a manner that discourages inflationary expectations, this would be anywhere near possible. You cannot have the frenetic progress Tom Friedman describes in his book without the well-functioning, reliable monetary regimes central banks have been sustaining.

This is the great responsibility of the strange species known as central bankers. It is an especially intense responsibility for the Federal Reserve, as the central bank of the largest economy in the world, which prints the world's most utilized currency. One cannot make monetary policy without being aware of the forces of globalization acting upon our

economy. Nor can one be oblivious to the need for us to conduct our policy without an awareness of how what we do impacts markets, and therefore, economic potential, worldwide.

A few weekends ago, I went to College Station, Texas, to watch Texas A&M play Baylor. One of the A&M regents tried to explain a coach's decision that I had questioned. I couldn't understand the logic after several tries. So my friend said, "Look, Harvard boy, let me lay it on you in Aggie Latin: Bubbus, sed possum explicare. Non sed possum comprehendere. Bubba, I can explain it to you, but I can't understand it for you."

This evening, I have done my best to explain that there is a connection between globalization and monetary policy. I hope you take what I have said and come to understand what it means.

The night is long. So, for the sake of ideological balance, in closing let me evoke Keynes and his observation that in the long run, we are all dead—a proposition that still holds in a globalized world. Bibamus, moriendum est. Death is unavoidable; let's call it quits and have a drink.

Globalization and Government Policy

Richard W. Fisher, President, Federal Reserve Bank of Dallas
Remarks at the Fifth Annual Federal Reserve Bank of Philadelphia Policy Forum, December 2, 2005
Complete speech: **http://www.dallasfed.org/news/speeches/fisher/fs051202.html**

Globalization describes the economic reality of our times. In simplest terms, it means a nation's economic potential is no longer defined by political and geographical boundaries. Indispensable to the concept is factor mobility. The globalizing world we live in is one in which the goods, services, capital, labor and ideas that propel economic growth are increasingly free to migrate to where they are most valued and can work together most efficiently, flexibly and securely. These key factors of production avoid bureaucratic restrictions that lock them into outmoded methods and organizations and intrusive governments that limit their ability to adapt to a rapidly changing economic environment. They look for maximum profitability in returns on capital and the lowest tax burden on the sweat of the brow. In short, they constantly search for the environment with the fewest obstacles to success and—this is a point we must always remember—they are increasingly free to move to more welcoming environments.

Economic policies, of course, can have a big influence on decisions about where it is best to do business. A globalizing world means governments, national as well as regional and local jurisdictions, are forced to compete to attract and to hold these increasingly mobile factors of production.

U.S. business leaders have come to grips with the inevitability of global competition. Now, our policymakers must prove they can do the same.

I think monetary authorities around the world have gotten the message. They have achieved a new discipline, thanks in part to the competition created by globalization. Open financial markets allow investors to seek countries with stable money and shun those places where the value of their capital will be eroded. A clear result of globalization has been inflation rates converging at lower levels in North America, Asia and Europe. When it comes to accommodating inflation, central bankers everywhere have become, to quote my late, great father-in-law, Congressman Jim Collins, tighter than a new pair of shoes.

Has globalization brought a similar disciplining force to fiscal policy? It is hard for me to stand here today, among eminent scholars who delivered chapter and verse on America's fiscal profligacy, and tell you we are seeing better fiscal policies. Yet, I believe that globalization is having a beneficial impact on fiscal decisionmaking and that, while the United States is hardly virtuous on this front in an absolute sense, it is in better shape than most of its competitors.

Let me first turn to the discipline imposed on fiscal policy by global forces.

Take taxes. In a world where capital moves across borders more freely than ever, globalization heightens tax competition among nations, just as it does among states in this country. Indeed, we are seeing the average tax rate come down in the world's most open economies as nations compete for productive resources. Among OECD nations, the average top corporate tax rate fell from 38 percent in 1996 to 31 percent in 2002. Estonia has instituted a flat tax. Japan has learned through painful experience what it means to raise taxes. Poland and Germany are in the midst of tectonic political battles in which tax issues loom large. And China rarely, if ever, actually collects significant taxes from the corporate sector. In today's world, I doubt you can earn many brownie points, let alone raise more revenues, by increasing taxes on investors who are free to roam.

One would think that globalization would lead to similar discipline on the spending side. In theory, increasingly mobile companies and workers should not be fooled by a government that promises ever-growing spending not paid for by existing or new revenue streams. They should anticipate corrective measures down the road and adjust their behavior accordingly—at least if the theory of rational expectations has merit.

When people fully understand the economic environment in which policy is being made—that is, when they are rational—policymakers' power to manipulate the business cycle for short-term political gain is mitigated. In theory, fiscal authorities who face rational economic agents should find they can't use deficit spending to stimulate GDP because people will simply save more in response to today's increased public debt, anticipating tomorrow's higher tax bills.

But the deficit-reducing pressures anticipated by theory have yet to arrive in reality.

The United States continues to be a preferred destination for foreign capital, the most mobile of factors. These flows of international savings have made it easier—or at least less painful—to finance our deficits at low interest rates. Without capital from overseas, the growth of government spending might have crowded out the growth of household spending. Readily available foreign money has helped finance our surge in consumption spending and housing investment.

Why is this? I will offer one suggestion, drawing on my past experience as a market operator and putting on my old hat as an asset allocator: Other potential destinations for significant investment are actually doing worse than we are in terms of fiscal policy.

OECD data, which cover state and local governments as well as national budgets, show our public sector in the red at a projected 3.7 percent of GDP this year. In contrast, Japan is at 6.5 percent, Italy at 4.3 percent and Germany at 3.9 percent. France is only marginally better at 3.2 percent, according to the OECD. The assumptions behind these numbers may be a bit dodgy: For example, it is not clear whether the OECD data capture the impact strong U.S. growth is having this year on the federal deficit and on state and local revenues. A similar revenue swing is clearly not occurring in the budgets of the lander and central government in Germany, or in France. French Finance Minister Thierry Breton's straightforward revelations just a few days ago make it clear that his country's fiscal predicament is far worse than previously reported.

Here is the point: In terms of investors looking to allocate their capital, and the impact they have on the price of money, you cannot think of U.S. fiscal policies in strict isolation from what is happening in other countries. ■