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Mr. International

Dallas Federal Reserve President Richard Fisher brings a global perspective to central banking.

A TIE exclusive interview.

TIE: **How do you feel about the U.S. economy?**

Fisher: Of all the rich countries—notice I don't use the term "industrial" anymore because we are "post-industrial"; we're a service-driven, cyber-enhanced economy operating on the highest rungs of the value-added ladder—the United States is the only one that has consistently grown in the face of all the new competition that has come on stream since the fall of the Wall and the demise of Mao. The continental Europeans have recently begun to restructure their economies and grow; Japan is now coming out of a prolonged recession. But our growth and that of England, Canada, and Australia has been consistent and unique. The United States is the grandest of all economies: Our GNP now exceeds $13 trillion; the output of the 12th Federal Reserve District, headquartered in San Francisco, exceeds that of all of China in dollar terms; the output of the 11th Fed District, headquartered in Dallas, exceeds that of India by 25 percent. Ours is a gargantuan economy and also a very dynamic one.

I believe this is because we have two great assets. First, we don't suffer the sociological plague of envy. If we see that Bill Gates or Warren Buffet or Oprah Winfrey is richer, we want to be like that person. We don't seek to bring them down; we seek to emulate them. We're a highly entrepreneurial, adaptable soci-

ety that seems almost genetically programmed to succeed economically. Second, and deriving from this characteristic of being driven to succeed, we have been the cradle of technological progress and, most recently, cyber-innovation. As such, the United States is well positioned to be a major beneficiary of globalization, as long as politicians refrain from interfering with the genius of the private sector and central bankers keep inflation from distracting our entrepreneurs and workers from doing what they do best: innovate, grow profits, create new jobs, and give rise to ever-improving living standards.

So the short answer is that we may suffer occasional setbacks such as slower growth or market corrections, but the underlying structural dynamic of the United States is profoundly competitive and pro-growth. I am optimistic about America's economic fate.

TIE: **You mention "market corrections." Why?**

Fisher: I managed a hedge fund for a long time. [Mr. Fisher was Managing Partner of Value Partners, Ltd., a Dallas-based hedge fund, from 1989–97; the fund earned a return of 23.6 percent compounded annually for its investors.] I have been a "market operator." I know from experience that markets are manic-depressive. They overshoot. This tendency may or may not have been mitigated by the incredible acceleration of investment technology—from the speed with which computers can perform valuation calculations, to the global distribution of knowledge. But I don't think we've conquered the primal instinct to overshoot. There will always be a risk of market corrections. That is the nature of capitalism; it is not meant to be predictable and certainly will never be boring.

One thing that fuels the potential to overshoot in the credit markets is that when yields are low, people reach for yield. It's natural—it's been going on practically since the ancient Lydians invented money!

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When the yield on highest-quality credits are low, all kinds of "new paradigms" spring forth in the search for greater returns. When they do, investors and financial agents too often forget the difference between price and value. All the modeling and stress testing in the world is, in the end, a mathematical and computer exercise, especially for synthetic securities. In the end, you don't know the "value" of a security or a bundle of securities until you try to sell it. The recent Bear Stearns case, where collateralized debt obligations were found to be worth a fraction of their modeled value, is a healthy reminder of these basics.

After a period of surging financial returns and enormous financial innovation in the quest for enhanced returns, there inevitably are corrections. And when they occur, there are always sobs and tears. I don't mind tears among individual market operators as long as we don't get *tears* in the fabric of the financial system. I do not believe the Federal Reserve's job is to protect against the failure of specific risk-takers. Its job is to protect the system itself.

TIE: **With all the financial innovation you talk about and the advent of globalization, we are seeing an extraordinary period of wealth creation and poverty reduction worldwide. What scares many people are the rumblings of both U.S. political parties beginning to embrace protectionism. What would be the unintended consequences of moving in this direction?**

Fisher: Our political leaders are the elected representatives of the people. In terms of actions they might take on the trade front, I trust good economic sense prevails.

The good news is that our former ideological and military enemies have accepted some form of capitalism. I don't think we've really seen the ultimate divi-

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dend of that change because it's so new. Nearly three billion fervent capitalists have been added to the system in recent years in China, in the former Soviet Union, in Vietnam, in India. They want to make profits. They want to improve their living standards. They want to move up the income ladder.

Our job is to keep exploiting—in the nicest sense of the word—this situation and staying ahead of the curve. In his day, Winston Churchill talked about the "superfine processes." He urged that a country like England should take all the cheap inputs available from the rest of the world and use them as the stuff of moving up the ladder into the superfine or highest value-added processes, which is where the lion's share of profits are made. We do this today. And not just with commodities or textiles or cheap manufactures but in information technology. For example, we import from India the low-cost, more easily programmable, rote software. We use cheap inputs from abroad to drive down the cost of goods sold here and at the same time to drive higher up Moore's Curve—to move up into the superfine processes of the cyber-age, where the greatest profits and advances are made.

If you look at our export numbers, they're being increasingly driven by services exports at the highly sophisticated end of the technology spectrum.

Much protectionist invective is being leveled at China. In the late 1970s, I was on the team that President Carter sent to China to normalize relations. In the late 1990s, I was the Deputy U.S. Trade Representative and part of the team that negotiated China's entry into the World Trade Organization. I know the games the Chinese play and the techniques Chinese negotiators employ. If they violate the rules of the road, they should be held accountable; that is why we wanted them in the WTO. But as to sweeping protectionist initiatives, I pray our elected leaders will resist the instinct, however politically tempting. For in reality, if they pick one country against which to raise protectionist walls, say China, next it will be Vietnam or India, and suddenly we will be back in the 1930s.

***TIE:* One of the things that has allowed the United States to develop is that Americans always welcomed capital flows. Policymakers made it easy and safe for people to invest in the United States. But while China and India are making tremendous progress, their governments retain a great deal of control over enterprise and industry. Now those governments want to use their reserves for direct foreign investment. What are the politics of having foreign state enterprises owning U.S. private-sector firms?**

Fisher: The current angst over "sovereign funds" brings back memories. We worried about this with the OPEC kingdoms, when we had the "petro-dollar recycling" exercise in the 1970s. We fretted about Japan, whom many considered a centrally controlled economy, buying up America in the 1980s. When I was a trade negotiator in the late 1990s, we worried about German government ownership of the express delivery companies and telephonic systems seeking to make acquisitions in the United States.

I think you have to be careful not to throw the baby out with the bath water. We run a large current account deficit. We finance it with capital inflows. In reaching for yield and seeking enhanced returns, investment pools—be they sovereign or private—are moving away from plain vanilla investment instruments. We want as much of that investment capital as we can get. We do have procedures to protect against the potential for foreign investment to compromise our national security interests. But I don't lose sleep over Norway's becoming a threat to the United States by virtue of its having the world's third-largest sovereign fund, which might or might not invest in a U.S. private equity deal. Maybe it's because I am Norwegian on my mother's side, but I hope a big, fat share of that fund and other sovereign funds will be invested here so we can use it to grow our economy!

***TIE:* Globalization is going to be the hot topic in the presidential election cycle. What are your thoughts on the issue?**

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Fisher: I'll stay away from presidential politics. I did take leave of my senses earlier in my career and ran as the Democratic Party nominee for the U.S. Senate from Texas, so I know the kind of pressures that candidates are subjected to in a national campaign. And I note that our political leaders harbor many of the same fears or concerns about globalization that political leaders in other countries do. The point is that this is not unique to this election cycle.

Some very thoughtful people worry that globalization might increase income inequality. There is no disputing that there is income inequality in the world, within nations and between nations. It has ever been so. If you look at the raw income and inequality numbers within countries, you'll generally find more inequality at both ends of the income spectrum—in rich and poor countries—than you do in the middle-income countries. However, these ends don't contain comparable countries. At the low end of the spectrum, no nation has free markets or social mobility; instead, they are generally run by a narrow elite group—in many places by tyrants—who direct most of the nation's wealth into a small number of pockets while the masses starve, thus leading to a wide income distribution. Nations at the upper end of the income spectrum are different. They tend to be free economically, and the wide bandwidth there comes from people having the opportunity to pursue income, which the success of the system affords them the opportunity to do. Here is the point: As nations get richer, we see wider income distributions at higher average income levels. Globalization is a mechanism by which the world gets that opportunity. And that's what we should focus on—opportunity, not inequality. I think it's important to realize that globalization has lifted the world's living standards—it's a tide that lifts all boats. Whether it narrows differences in income among countries or widens them within countries—a typical finding—is not as important as whether it brings upward mobility for the masses. It does.

To quote Winston Churchill again: "The inherent vice of capitalism is the unequal sharing of blessings; the inherent virtue of socialism is the equal sharing of miseries." The world has thrown off the yoke of miserable socialism. It has embraced capitalism with all of its imperfections. The transition mechanism for the newly embraced capitalism is globalization.

Just looking at the income distribution effects of globalization may overemphasize the "unequal sharing of blessings" bit. We need also to look at the consumption side. If you're a single mother living in Mount Vernon, Texas, a relatively poor rural town, you drive over to the Wal-Mart in nearby Mount Pleasant because at low cost, you can put shirts on your children's backs and shoes on their feet. The sources of those shirts and shoes are probably Bangladesh, China, or Vietnam. When you broaden the aperture of your lens to a worldwide view and see pictures of people in Bangladesh or Africa using a cell phone or cheap computer, you realize that the consumption side of globalization provides a different perspective on the issue than a simple-minded focus on the income and production sides. Dishwashers, televisions, cell phones, medical diagnostic devices—more people on earth have access to these things, thanks to the ability to spread costs across a global market that provides for huge economies of scale. Yes, relatively speaking there are huge dispari-

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—R. Fisher

ties in income. But in absolute terms, accounting for the consumption that is possible at a given income level, the progress enabled by globalization has been revolutionary. There is still too much poverty in the world. But it is a fact that, as globalization has intensified, real growth worldwide these past several years has been the highest in post-WWII history.

TIE: **Central banks appear to be debating the disinflationary impact of globalization. It seemed obvious at the beginning of this process that globalization was lowering prices, but as developing economies have expanded and increased their appetite for commodities, the picture regarding globalization's effect on prices has become less clear. Has a consensus been formed on this issue yet?**

Fisher: No. I gave a speech at Harvard in November 2005, using the example of economist Joseph Schumpeter's railroad. When a new railroad is built through virgin territory, everything that was optimal before is suddenly no longer optimal. We saw that happen when the transcontinental railroad was built in the United States. It changed the whole shipping pattern of America, drove down costs and developed areas that otherwise wouldn't be on the map. Cyber-enhanced globalization is a powerful Schumpeterian railroad coursing across the global economy, at a speed we really can't measure. It is changing the optimal distribution of everything we know.

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It stands to reason that when the talents of nearly three billion people were released from communism and bureaucratic constraint, a disinflationary supply shock of significant proportion swept across the world. And as those people have become richer and started to consume more, it is obvious that a demand-pull influence is being exerted. I personally believe that we need to better understand the push and pull of globalization on inflationary dynamics here at home. I am not alone. ECB President Jean-Claude Trichet and Bank of England Governor Mervyn King have spoken quite a bit about this topic. The dynamic of globalization goes beyond the accounting of trade and current account measures. And I personally believe that it evades the classical equilibrating mechanism of exchange rates for currency. In a world where tasks as well as product pipelines and inventory management and capital allocation can be shifted by the stroke of a keyboard from one geographic location to another through directions communicated in the ether of cyberspace, we simply do not know the precise impact of globalization on the gearing of our domestic economy. We do know, however, that we can no longer rely on a closed model mindset, however large our domestic economy.

Incidentally, a careful reader would note that for the first time in the minutes of the Federal Open Market Committee, there was reference in the May 2007 meeting to how capacity utilization overseas might be impacting domestic inflation here. We are making an effort to comprehend what globalization portends.

Our entire research team at the Dallas Fed is devoted to better understanding globalization. We hope to build a Globalization and Monetary Policy Institute. Otmar Issing and Charlie Bean are on our advisory board, as are John Taylor, Ken Rogoff, Marty Feldstein, Glenn Hubbard, and Nobel laureate Finn Kydland. At this stage, we have a lot of questions about the impact of globalization and a few theories. We do not yet have many answers, however.

TIE: **Focusing exclusively on the United States, what are your biggest concerns about the U.S. economy?**

Fisher: Well first, I pray that my colleagues and I on the FOMC will get it right—that we will live up to the dual mandate we are charged with and execute it as flawlessly as is humanly possible. I am very comfortable with Ben Bernanke at the helm. He is a thoughtful man and a good listener; importantly, he is fair-minded. And very smart. He has a great group of first-rate brains to

draw on at the FOMC, present company excluded, and he does so very effectively.

When I first came on board the Fed, Alan Greenspan told me that all I had to do to get policy right was to pursue the truth. Every member of the FOMC takes that to heart. Ben Bernanke has to lead the Fed in a period of tremendous economic change. It's almost a new epoch and, to get back to Schumpeter, many of the things that were optimal before are no longer optimal. Those who are honest with themselves know we don't have all the answers. There are no fixed, all-knowing equations; monetary policy is a judgmental business. So you get the best people you can around the table and you let them open up. Ben does a magnificent job of that. I trust that with this dynamic, we will continue getting it right.

***TIE:* But are you concerned about political influence as you strive to "get it right"?**

Fisher: Part of our getting it right involves dealing with the hand we are dealt. I have to admit that I worry about two issues in the hands of our political croupiers. One is immigration. The other is our open-ended national medical insurance liabilities.

We know as economists that immigrant labor helps hold costs down. We know as a society that America was built by immigrants. That's the easy part. The issue is the volume of immigrants that lawmakers allow into our country and the legal terms of entry.

The most discussed aspect of immigration is the low-end labor force, principally Mexicans and Latin Americans who come into the United States to do jobs that others do not wish to do. I also worry about the opposite end of the spectrum and our need for high value-added immigrant flows. We are a service-driven economy that is dependent for growth on science, technology, and finance. Brains are the capital base of the American economy. To grow the economy, we need all the brain power we can get.

In June, I was the commencement speaker at the University of Texas Southwestern Medical Center—one of the leading medical schools and research centers in the country. What struck me during that commencement was, looking at the list of names of the new doctors and Ph.D.s, it was clear that few of their grandparents were born in the United States or even in the Western Hemisphere. We rely on well-educated, hard-working immigrant families to provide us with doctors, physicists, chemists, mathematicians, economists, and the other foot soldiers of a high value-added economy. That much is clear for anybody who walks the campuses of our best centers of higher learning and research.

Most of our graduate schools are richly populated with students holding foreign passports. We subsidize education at the university level in America through endowment drives in the private sector and with state monies because tuition doesn't cover costs. We have the greatest universities in the world—the finest are all here in the United States, save Oxford and Cambridge and maybe one or two in Asia. We educate the best brains in the world. And once we are done, having subsidized their education, we send them away, denying them visas. It's like spending millions to drill an oil well, finding oil, and then giving it away. Except unlike an oil well, a brain never runs dry.

Globalization has lifted the world's living standards.

I am hopeful our political leaders will see the light here. We need as many of the world's best brains to stay here as we can get, be they American or foreign-born, and we ought to be proactively devising education and immigration policies accordingly.

So I hope we don't let emotion get the upper hand on the immigration issue. I hope our political leaders get it right.

***TIE:* And the second issue on the political front?**

Fisher: Another issue I am deeply concerned about is the horrific hole we have dug for ourselves with Medicare. This is the Big Daddy of all fiscal issues. Here is a stat that says it all: The discounted present value of Medicare—in common language, the current value of the gap between what we will take in and what our government has already promised to pay out—is $70.5 trillion. That's in today's dollars. It is over five times the present value of the unfunded liability of Social Security. It represents well over 50 percent of all projected federal income tax revenues from here to eternity. The new prescription program under Medicare D alone exceeds the liability of Social Security. This is not a pretty picture.

Why would a central banker list this as one of his biggest concerns? Well, bad fiscal policy begets

demands for bad monetary policy. When fiscal policy gets out of whack, monetary authorities face pressure to monetize the debt. This would be a cardinal sin. We must make very clear that the Federal Reserve is never, ever going to be a handmaiden to bad fiscal policy.

***TIE:* Having made that clear, do you have any thoughts to share on the broader matter of the Fed's communications strategy?**

Fisher: The sincere intention of every member of the FOMC is to make sure that we live up to the mandate given us by Congress, to promote "maximum employment, stable prices, and moderate long-term interest rates." Achieving price stability is the key to delivering on that mandate. We know that markets anticipate things. Any economist will tell you today the key issue in maintaining stable prices is containing inflationary expectations. You want the private sector to be able to plan with as much certainty as possible on what the major influences will be on its behavior, including monetary policy. And you want to do your level best to not induce economic operators to adopt inflationary behavioral patterns by thinking the central bank will validate inflation. So you want to be able to shine as much light as is prudent on your intentions and your methods. The issue is prudence. Monetary policy is a deliberative process. Too much exposure of the to's and fro's of internal deliberations might be more confusing than enlightening.

***TIE:* The Fed has made a lot of progress on that over the years. People understand the Fed better than they did before. The Fed was once a very mysterious place. It's come a long way. Toward that end, would you comment on any internal discussions on inflation targeting?**

Fisher: No.

***TIE:* In our view, the Fed has become basically a giant theater. Alan Greenspan was its Laurence Olivier. Do you agree?**

Fisher: You know the story: Ronald Reagan gets elected president and the Pope purportedly calls him and says something like, "Mr. President, you and I are blessed. We were both actors. We understand that you are no longer Ronald Reagan, you're a persona, the President. I'm no longer Karol Wojtyla, I'm the Pope." That happens when you assume a position of high importance in any policymaking position, be it in the executive branch, legislative branch, Supreme Court, or the Fed. What you say and the way you say it and all the nuances you convey are as important as what you do, because you are on the policy stage and everyone is watching. The Fed and particularly the Chairman and the FOMC principals have to set themselves aside and perform on that stage according to what is in the nation's best interest as central bankers. I don't think of this as theater. I think of it as performing a serious, highly demanding professional role.

I believe people view the central bank of the United States as having impeccable integrity. It's a hard-earned reputation. I don't know of a single participant in the FOMC process, from the chairman to the bank presidents, who is driven by anything other than the highest standards of professional devotion.

Mind you, you can say the same for the Bank of England or the ECB or the Reserve Bank of Australia or Banco de México or any other central bank. They are all devoted to keeping inflation low in order to lubricate the engine of sustainable growth. Therein lies something of an invisible regulator that keeps us all focused. In a globalized economy, with capital and businesses and labor able to migrate to wherever they might earn a superior return, there is intense pressure for central bankers everywhere, including the Fed, to keep inflation under control. In this sense, to get back to your theatrical analogy, Shakespeare was right: All the world's a stage, and all the men and women—including the central bankers—merely players.

***TIE:* Thank you very much.** ◆

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