Comments on Monetary Policy and an Annual Texas Economic Review

Remarks before the Dallas Business Club

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By Richard W. Fisher

Thank you, Alden [McCall]. I feel right at home in a room full of MBAs. As many of you know, I am not a PhD economist like the majority of my colleagues sitting on the Federal Open Market Committee (FOMC). I admire my colleagues tremendously for their intellectual capacity and their well-trained insights into the dismal science of economics and the arcana of monetary policy, but I am proud of just being an MBA. I was privileged to attend all those schools Alden mentioned: the Naval Academy, Harvard and Oxford. But I feel that the MBA program at Stanford Business School prepared me best for my career as a banker, a money market operator, and for the past decade, a policymaker at the Federal Reserve. (Though plebe year at Annapolis probably best equipped me for the sleep deprivation and the pressure we operated under during the financial crisis). So Alden, I begin with a tip of the hat to the MBAs you have assembled this evening.

I am going to talk about Texas tonight, this being my annual report on the status of the Texas economy. I will walk you through a series of slides that illustrate the strength of the Texas economy, a series of economic records we have set this year, and to provide a balanced view, some of the growing pains that we are encountering. But first, I want to make a comment on monetary policy.

Thinking Outside the Box

It strikes me as timely for the Fed to consider implementing one of the possible options under the "normalization principles" the FOMC articulated in September: allowing our security holdings to run off as the bonds in our massive portfolio mature.[1] Before you jump out of your skin at this "radical" thought, let me ask you to consider the following.

The 10-year Treasury note has rallied in price and declined in yield to 2.29 percent. German 10-year bunds, the equivalent market-anchoring European security, are trading to yield 0.74 percent; the Japanese 10-year yields 0.42 percent. The spread between the U.S. and the German sovereign yields is slightly narrower than it was at the end of third quarter 2014, but it remains historically large and attractive for investors.[2] Hold that thought.

Now, if you read page C3 of today's *Wall Street Journal*, specifically the article titled "Watchdog Warns of Risks in Markets" about the risks of a repeat of the bond market turmoil of October and concerns about market stability as seen through the eyes of the Office of Financial Research (a bureaucracy of some 225 people and growing, created by the Dodd-Frank law), you would have noted the following sentences: "A reduction in securities that are available to lend against in financial markets—such as Treasury bonds and asset-backed securities—also is fueling...volatility. The securitization markets have shrunk since the financial crisis and the

Federal Reserve has further reduced the amount of available securities by snapping up trillions of dollars in bonds in recent years." Let me repeat that last clause: The Federal Reserve has further reduced the amount of available securities by snapping up trillions of dollars in bonds in recent years. To be precise, $1.7 trillion of Treasuries and asset-backed securities were purchased under QE3, on top of the $2 trillion purchased under the previous rounds of quantitative easing.

To be sure, we have instituted programs to counter this problem: We have developed sophisticated operations whereby we sell assets in our portfolio and promise to buy them back at a later period. This is known as our overnight reverse repurchase agreement (ON RRP) facility, and its net effect is to shift longer-term securities out of our portfolio and into the hands of market operators. This has expanded the traditional reach of our New York desk, where the aggregate portfolios of the 12 Federal Reserve banks are traded under directives given it by the FOMC. Thus the Fed's reach—some would say *intrusion*—into trading markets has been expanded.

Now, let's bring together these observations with the thought I asked you to hold earlier. It strikes me that given current circumstances, it would do no harm to start slowly trimming our holdings by letting them roll off as they mature. My sense is that presently, we could do this:

> (a) While still maintaining the attractiveness of investing in Treasury and agency securities relative to other highly liquid sovereign markets and not sparking significant increases in rates;
>
> (b) Simultaneously providing some alleviation of the collateral shortage we have helped create, and;
>
> (c) Reducing the need for the New York desk to perform the complicated jujitsu we at the FOMC have tasked it with in creating alternative strategies that stretch its traditional mandate and which may give further rise to congressional criticism of the Federal Reserve and a New York Fed that some influential lawmakers already consider to be either too big for its britches or not being able to fill out its suit. This would make crystal clear to Congress and the public our stated desire to make the ON RRP facility a temporary one that will be eliminated when it is no longer necessary.

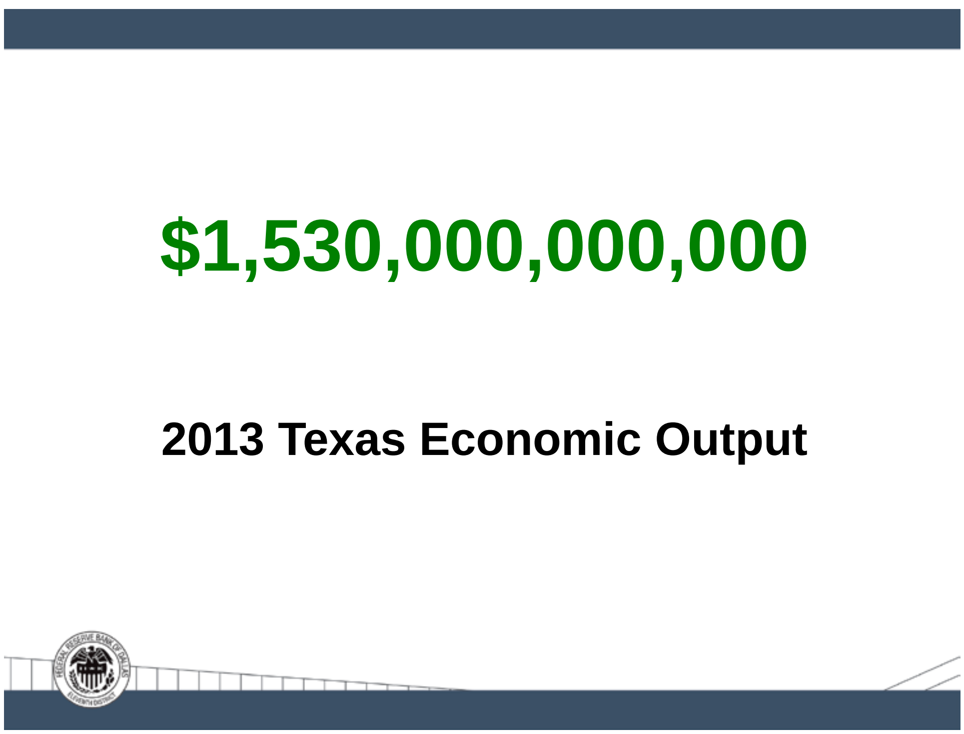
Mind you, the above proposition does not imply any rush to raise the fed funds rate or its equivalents, such as the rate on excess reserves. That will depend on progress made toward meeting our dual objectives of maintaining price stability around the FOMC's 2 percent target while facilitating full employment. Nor should it be interpreted as a criticism of the very able people we have on the trading desk: I hold them in highest regard; they perform their duty admirably. It simply is addressed at seizing the moment to kill three birds with one stone and do so with minimum violence to the market.

Of course, a more effective way to put collateral back into the market would be to sell outright a carefully measured portion of our portfolio. There could even be room for the market to stomach this in its current condition. But in my opinion, this might be too radical a departure from the exit principles we announced and would risk undermining confidence in the FOMC.

This is my personal view. I realize it represents thinking “outside the box.” But in my final four months at the Fed, I plan to urge my colleagues to think more outside the box in this and other ways in the interest of securing sound money, a sound economy and sound markets.

And now to some Texas brag.

Texas Brag
Allow me to walk you through some charts and comment on each on them.



US States Renamed for Countries with Similar GDPs, 2013

SOURCE: Bureau of Economic Analysis; International Monetary Fund (nominal, not PPP-adjusted); American Enterprise Institute's *Carpe Diem* blog, post by Mark J. Perry, June 12, 2014.

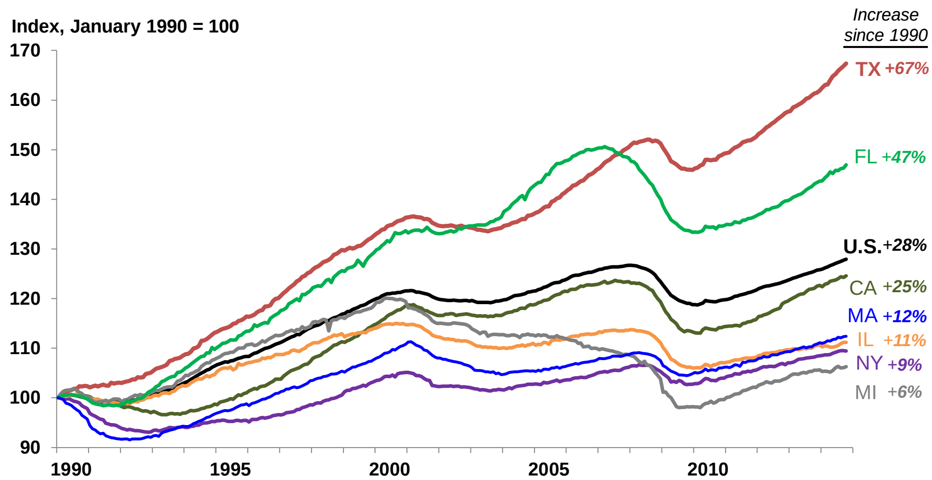
A Record-Setting Year in Texas

- State output continues to climb to new heights.
- Employment growth is broad-based across industries and income groups.
- New highs for income per person.
- Another year as top migration destination from other states.
- Highest percentage of home mortgages with positive equity.
- Construction contract values reach a record.
- Oil & gas production soars along with refining capacity and exports of petroleum products.

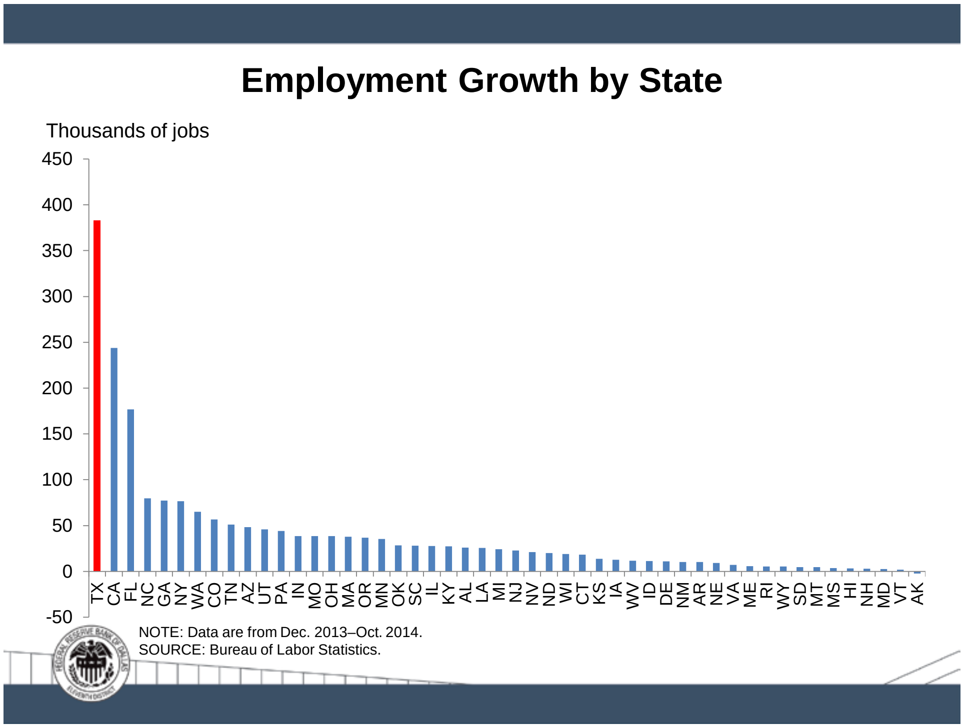
The Lone Star State Shines Bright

- In the past several years, growth in energy, exports, professional and business services, manufacturing, and trade, transportation and utilities have helped drive growth.
- Full-year 2014 job growth is expected be ~3.5%, the current year-to-date run rate is 3.7% annualized growth (strongest since 1998).
- The unemployment rate is 5.1%, near a 6-year low and below the U.S. rate of 5.8%.
  - Notably, since the beginning of the recession, the Texas labor force has grown at a rate **10 times** the U.S. labor force
- Factors contributing to Texas' growth:
  - Larger share of fast-growing, fundamental industries.
  - Favorable long-term factors.

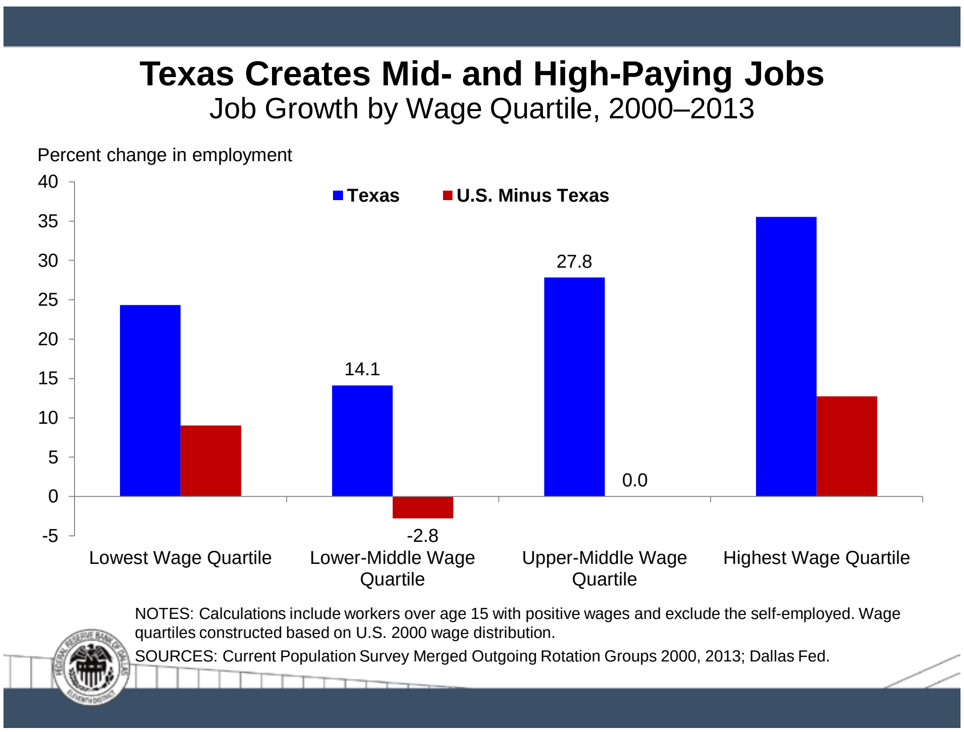
Total Nonagricultural Employment Since 1990 in Selected States



SOURCES: Bureau of Labor Statistics; Federal Reserve Bank of Dallas.

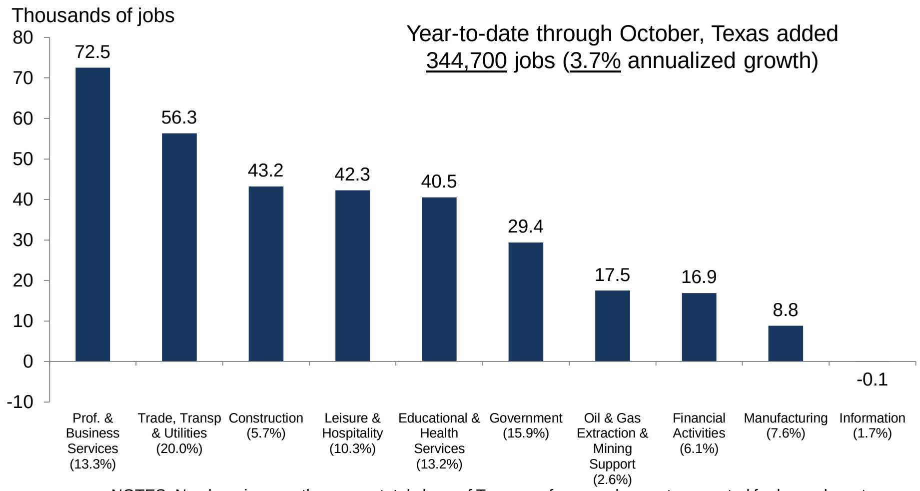


Employment Growth by State
Thousands of jobs
450
400
350
300
250
200
150
100
50
0
-50
TX CA FL NC GA NY WA CO TN AZ UT PA IN MO OH MA OR MN OK SC IL KY AL LA MI NJ NV ND WI CT KS IA WV ID DE NM AR NE VA ME RI WY SD MT MS HI NH MD VT AK
NOTE: Data are from Dec. 2013–Oct. 2014.
SOURCE: Bureau of Labor Statistics.



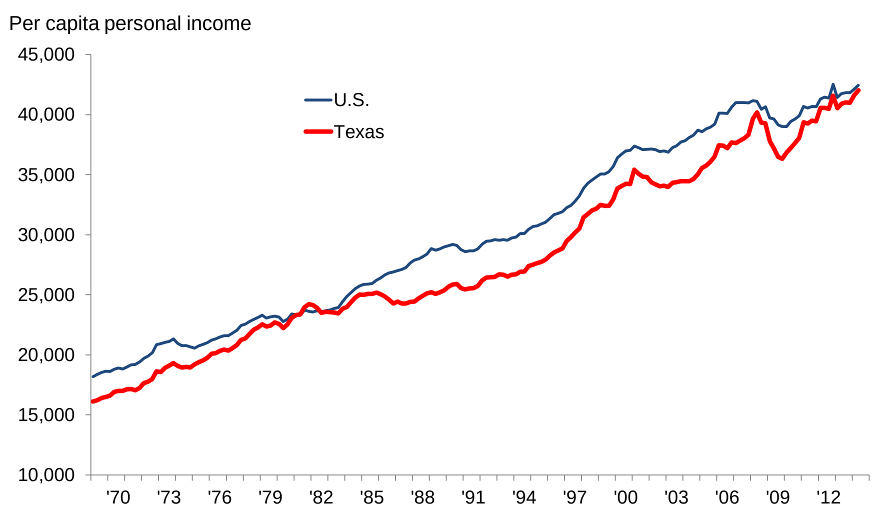
Texas Creates Mid- and High-Paying Jobs
Job Growth by Wage Quartile, 2000–2013
Percent change in employment
Texas
U.S. Minus Texas
40
35
30
25
20
15
10
5
0
-5
27.8
14.1
0.0
-2.8
Lowest Wage Quartile
Lower-Middle Wage Quartile
Upper-Middle Wage Quartile
Highest Wage Quartile
NOTES: Calculations include workers over age 15 with positive wages and exclude the self-employed. Wage quartiles constructed based on U.S. 2000 wage distribution.
SOURCES: Current Population Survey Merged Outgoing Rotation Groups 2000, 2013; Dallas Fed.

Texas Job Gains by Sector



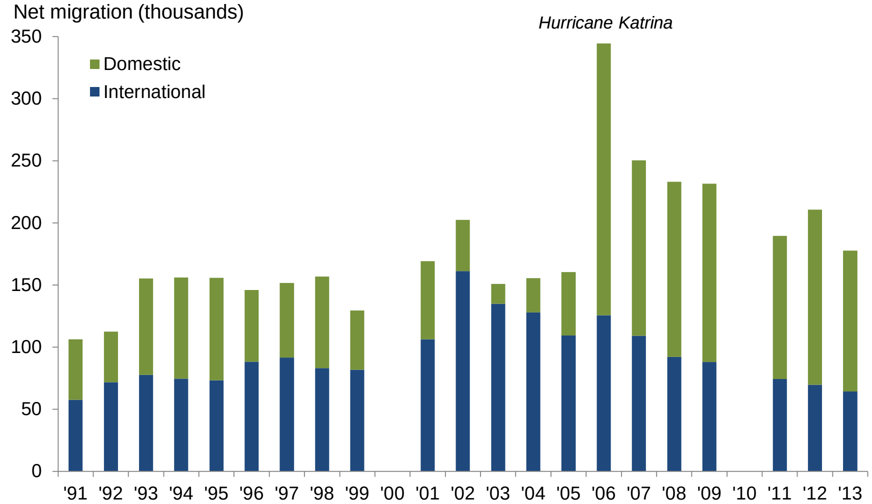
NOTES: Numbers in parentheses are total share of Texas nonfarm employment accounted for by each sector. These data are seasonally adjusted and early benchmarked by Federal Reserve Bank of Dallas.
SOURCES: Bureau of Labor Statistics; Texas Workforce Commission; Dallas Fed.

Record Income Per Capita



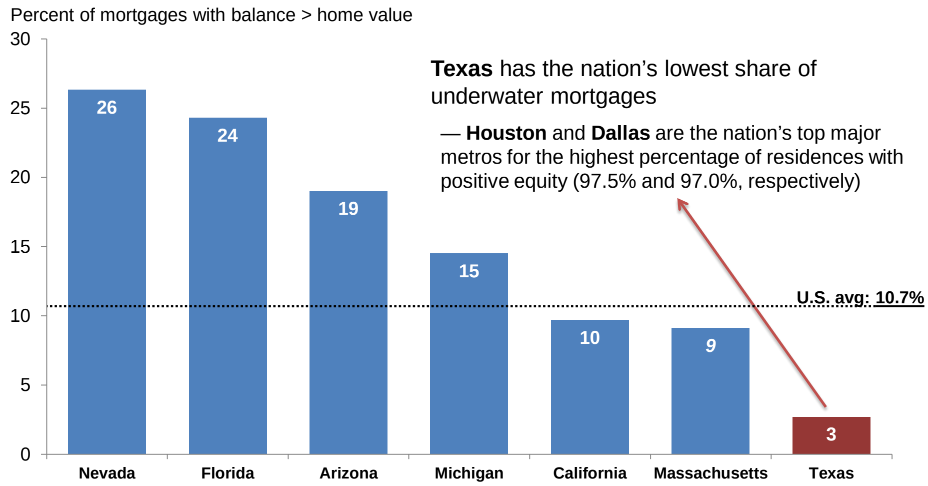
NOTE: Quarterly data inflation-adjusted to 2009 dollars.
SOURCES: Bureau of Economic Analysis.

Texas Remains Top Destination



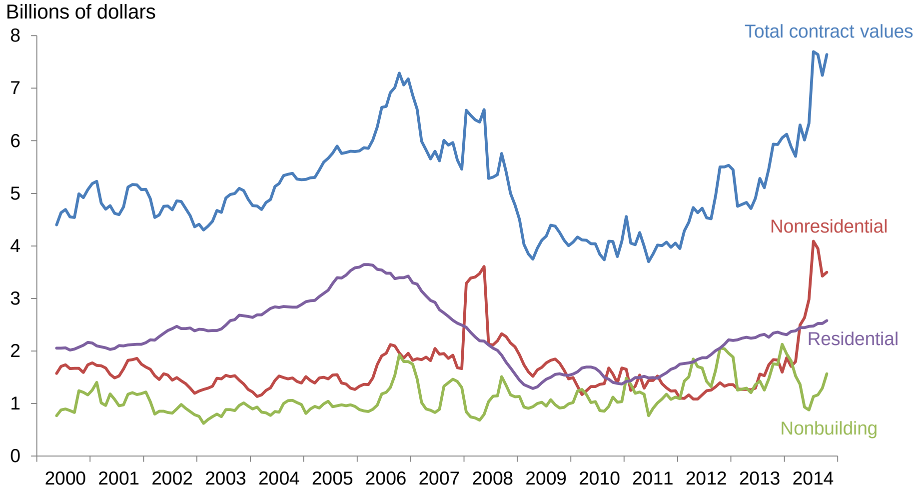
NOTE: Data are for July of the previous year to July of the year indicated. Decennial census years unavailable.
SOURCE: Census Bureau.

Texas Has the Highest Percentage of Home Mortgages with Positive Equity



NOTE: As of second quarter 2014.
SOURCE: CoreLogic.

Record Texas Construction Contract Values

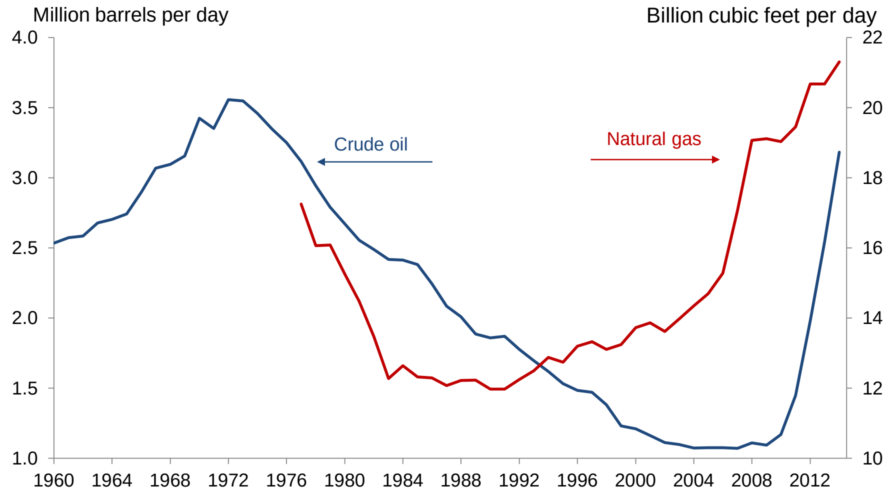


NOTE: Inflation- and seasonally adjusted, 5-month moving average. Last data point is October. "Nonbuilding" includes contracts such as streets, bridges and utilities.
SOURCE: F.W. Dodge.

Texas Is a Leader in the Energy Boom

- **Texas is the country's No. 1 producer of oil and gas.**
  - Record natural gas production.
  - Oil production has nearly doubled in Texas in the last five years, reaching its highest level since 1976.
- Texas' **3.2 million barrels/day of crude oil** is ~37% of U.S. total and ranks as the world's **sixth largest** crude oil contributor, more than Iraq and slightly less than Canada.
- Texas accounts for ~29% of U.S. **natural gas production** and is the world's **third largest** contributor, more than Norway and Saudi Arabia … *combined*
- Texas is home to 25% of U.S. refinery capacity and 60% of U.S. petrochemical production.
  - Record net exports of ~2 million barrels/day of petroleum products.

Texas Energy Production Has Soared



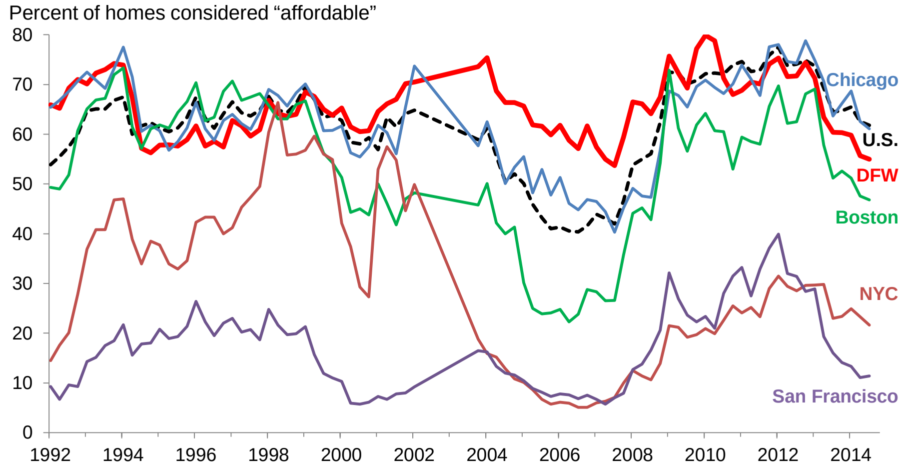
NOTE: Annual data except for final end points, which show August 2014 estimates.
SOURCES: U.S. Energy Information Administration; Railroad Commission of Texas.

Some Current Challenges

- **Acute labor shortages:**
  - Anecdotes of shortages for auditors, plumbers, welders, electricians, construction workers, truck drivers.
  - Wage gains statewide have increased to **4.3%** yr/yr.
- **Emerging price pressures:**
  - Houston is seeing wage inflation and shelter costs creep into overall prices: Core price inflation is **3.7%** yr/yr.
- **Bottlenecks in ability to export various oil & gas products:**
  - Texas' share of total world petroleum and coal products is ~6%; this figure will likely grow rapidly if recent U.S. regulatory ruling allowing some exports of condensate is expanded.
- **Declining affordability as housing prices have risen quickly and mortgage lending has slowed:**
  - Q3 '14 FHFA home prices increased 7.1% yr/yr in TX; 4.5% nationwide.

In sum, labor market tightness may restrain growth next year, the energy sector may cool a bit, and regional price pressures may cool

Housing Affordability Declining



NOTE: The Housing Opportunity Index assumes that the family spends 28 percent of its gross income on a 30-year, fixed-rate mortgage with a 10 percent down payment.
SOURCES: National Association of Home Builders; Wells Fargo.

A Record-Setting Year

- **Texas growth continues to outpace the U.S., with broad-based employment and income gains**
  - Texas has added 344,700 jobs year-to-date
  - 2014 job growth is running a full percentage point stronger than last year.
- **New records:**
  - Employment and income per capita.
  - Construction contract values.
  - Oil & gas production.
- **Yet, Texas is facing some growing pains:**
  - Emerging labor shortages.
  - Growing regional price pressures.

SUMMARY: Opportunities abound for Texas’ continued success; none of them have much to do with monetary policy

Thank you. And now in the great tradition of central bankers, I would be happy to avoid answering any questions you and your colleagues might have.

NOTES

[1] The FOMC's "Policy Normalization Principles and Plans" released on Sept. 17 is available at www.federalreserve.gov/newsevents/press/monetary/20140917c.htm.

[2] Over the past 15 years, the U.S. long rate has averaged about 40 basis points higher than the German long rate. Since January 2013, the yield spread has widened by 110 basis points to about 1.50 percent. Over the same period, German 10-year inflation expectations have dropped from 1.9 percent to 1.0 percent, or 90 basis points. U.S. 10-year CPI inflation expectations have dropped from 2.3 percent to 2.2 percent—just 10 basis points. So it is worth noting that the drop in German inflation expectations relative to U.S. expectations can account for most of the widening of the yield spread between these two sovereigns. For investors who measure performance in terms of nominal returns or returns against nominal indexes, however, the currently widened spread is relatively attractive.