

A Letter from the President

This is the second year I have had the privilege of serving the employees of the Dallas Federal Reserve and its branches in El Paso, Houston and San Antonio. During that time, the good women and men who run our operations and conduct our business have raised the Bank's profile to new heights, as evidenced by the operating statistics at the end of this annual report. Last year they processed over \$1 trillion in the form of 940 million paper checks and more than a quarter billion electronic checks. Some 6.1 billion banknotes worth over \$100 billion passed through our vaults.

Dallas Fed staff supervised and regulated 38 state member banks, 450 bank holding companies, and 29 agencies and representative offices of foreign banking organizations in the Eleventh District. They worked hard to promote financial literacy and community development so that citizens in our district will be better equipped to manage, safeguard and improve their financial well-being. And they sent me out on the hustings to give dozens of speeches, mercilessly inflicting me on the public and the economics profession.

My favorite theme has been the need to better understand the ramifications of ongoing global economic integration for our economy and the conduct of monetary policy. The nexus of globalization and monetary policy is the Dallas Fed's top research priority. We have been chewing on this topic for two years, and I am gratified by the progress we have



made in understanding it and the interest we see in academia and business and within the Federal Reserve System. We are onto something.

"The Best of All Worlds," this year's annual report essay by our chief economist, W. Michael Cox, and senior economics writer,

Richard Alm, contemplates how globalization changes the economy's gearing. It examines 10 ways a more integrated world economy impacts productivity and costs. All these channels are real, rather than monetary, in nature. But because they affect economic growth, they have potentially

far-reaching implications for Fed policymakers.

The Fed's mandate calls for keeping inflation low while maintaining maximum sustainable economic progress, a charge we cannot fulfill without understanding and weighing the forces driving productivity. Getting more output from existing labor and capital allows the economy to grow faster without creating price pressures. We saw this vividly in the 1990s, when the IT revolution led to surging productivity, lower costs and faster growth. The Fed understood that increased supplies of goods and services—*not* inflationary excess demand—fueled the expansion, and it wisely let the economy seek a higher growth rate.

The technologies that shaped the 1990s are also spurring globalization, which in turn increases market size, competition, specialization, capital flows, knowledge transfers, returns to scale and the other factors this year's essay identifies. These factors all conspire to raise productivity's level or growth rate—or both.

Higher productivity lowers costs. In this fundamental way, globalization raises the economy's speed limit, so policymakers can let the economy expand at rates that might once have been considered unsustainable. In a globalized world, faster U.S. growth might not carry the same inflationary implications that it did in a more closed world. Foreign growth may also matter for productivity and cost here at home.

This year's essay underscores how the world is fast becoming one big, integrated economy.

Consider a Barbie doll that's designed in America and made in China from Taiwanese plastic pellets, Chinese cloth and Japanese nylon hair, then marketed to a child in Dallas. Is that an American product or an Asian one? When a laptop computer in Boston performs remote heart surgery on a patient in Milan, is the procedure taking place in America or in Europe? When folks in the U.S. and other countries can work together so seamlessly, how can we pull them apart with the data? Perhaps we should care as much about output gaps, capacity utilization and unemployment rates elsewhere in the world as we do about our own.

We cannot make good judgments without proper measuring sticks. Data that do not reflect the world in which we live increase the chances for errors in decisionmaking. We need to develop much better measures for the global economy, particularly since services are becoming increasingly traded. Today, our most detailed measures of economic performance pertain to goods, a shrinking segment of our economy. We can tell you about agriculture and manufacturing in excruciating detail but have relatively little data about the fast-growing services sector—now 82 percent of U.S. employment.

Globalization's lower costs make assessments of living standards more elusive. GDP, our traditional yardstick, measures the economy based on what things cost, not on what they contribute to well-being. This is particularly problematic for the growing number of goods with decreasing average production costs.

Will India's GDP adequately reflect how much more living standards rise when four families buy \$30 cell phones than when one family buys a \$120 cell phone? I doubt it. The same contribution to India's GDP generated by the \$120 phone would mean three families did without. The more globalization drives down costs, the more GDP growth understates true advances in living standards. Getting the right measure of the advance might well alter our notions of economic progress, with ramifications for how we approach the goal of price stability.

The Dallas Fed will be taking its study of all this to the next level with the establishment of the Globalization and Monetary Policy Institute. I am deeply indebted to the prominent scholars and practitioners who have agreed to serve as our founding advisory directors: Charles Bean of the Bank of England, John Taylor of Stanford University, Martin Feldstein and Ken Rogoff of Harvard University, Glenn Hubbard of Columbia University, and Otmar Issing, former chief economist and executive board member of the European Central Bank.

We have high hopes that the institute will further the understanding needed to conduct policy in a globalized world so we can meet our congressional mandate to foster price stability and maximum sustainable employment.



Richard W. Fisher