The Current State of the U.S. and Mexican Economies: Where Do We Go From Here?

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The views expressed are my own and do not necessarily reflect official positions of the Federal Reserve System.

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I am with you today in Monterrey as the first part of a two-way exchange. Tomorrow, I will have the privilege of hosting my friend Guillermo Ortiz, the governor of the Banco de México, in Dallas. Today, he and Deputy Governor Elizondo have kindly arranged for me to be here. These two events, occurring together, are perhaps symbolic of the widespread ties that make Mexico and Texas inseparable and—I suppose for those who do not understand the profound nature of our bond—occasionally insufferable. We share a common history and a deep ongoing relationship that is unique among the United States.

The bond is personal for me. I grew up in Mexico—in the *Distrito Federal*. I spent my childhood there, and I recall it fondly. The first movie I can remember seeing was *Marcelino Pan y Vino.* (After seeing that magnificent film, I was never again afraid of the scorpions that inhabited our house in Mexico City.) I played Little League baseball for the Aztecas, playing second fiddle to my brother, whose team took on Monterrey for the right to represent Mexico in the Little League World Series. Angel Macias and his great Monterrey team, the appropriately named Industrials, won that game and went on to win the Series that year.

When we were not on the playing field, we were under the stern professorial eyes of the Sierra Madre School, where I learned Mexican history before I learned U.S. history. My mother used to say that until I was 18, I knew more about Hidalgo and Benito Juárez than I did about Washington and Abraham Lincoln.

My sense of humor—which my children will tell you is rather slapstick—was shaped by Mario Moreno Reyes, better known as Cantinflas. Of course, that is the sense of humor I had *before* becoming a stoic and deadpan central banker.

This is all by way of saying that I have a profound respect and affection for Mexico and her people. *Soy parte mexicano y con orgullo.* It is an honor to be here to speak to you today.

This morning, I plan to talk about the economies of the United States, Mexico and Texas. Before I do, however, I need to remind you that I speak only for myself, not for the Federal Open Market Committee, nor for any of the other committee members. So the thoughts I express this morning are purely my own.

Just last week, we had another FOMC meeting and collectively decided the best course of action was to leave the federal funds rate unchanged.

After participating in those discussions, it is always instructive to sit back and read the various interpretations that pour forth from well-meaning analysts about what action the committee took or did not take and what was said or left unsaid in the press release that follows the meeting. I liken this process to the ancient ritual of divining the future by slicing open animals to study their entrails. The analytical community dissects our statements and presumed intentions with the greatest of care. It is definitely less gory than the rituals of ancient civilizations. But it is only slightly more accurate as a predictor of the future.

If it would be helpful as you "study the entrails" of the FOMC, let me give you a quick précis of how I see the U.S. economy and its impact on the deliberations over monetary policy.

In roughly six weeks, the U.S. economy will celebrate the fifth anniversary of its current economic expansion. Where do we stand on the eve of this milestone? We have a serious correction taking place in the housing sector. Sales, starts and permits are all down, in a range of 10 to 25 percent over the past year. In a few local housing markets—especially in the coastal areas—home prices have peaked and are beginning to decline. This may well be the most over-anticipated and over-analyzed downturn in history. One prominent CEO recently told me that "the only situation that has received more intense analysis than the housing market was the birth of Brad Pitt and Angelina Jolie's baby." But it is a serious matter nonetheless, with not insignificant consequences for the economy.

Home prices in many markets ran ahead of themselves, outstripping rents, incomes and demographic trends. Cheap financing combined with mortgage finance "innovations"—another name for speculative leverage facilitated by excess liquidity—added to the fervor. Indeed, one can make a cogent argument that the housing market excesses were due as much to financial construction as to good old-fashioned physical construction, and that the spigot of liquidity that bloated the stock and prices of housing was open longer than it should have been in a world of less ingenious financial engineering. Regardless, the market for residential real estate had to adjust, and it is now doing so.

Joseph is patron saint for home buying and selling. If you were to have read yesterday's *Orlando Sentinel* newspaper, you would have discovered that there has been a run on statues of St. Joseph in various states as fear of the downturn in housing markets has spread. Sellers of homes are burying his statue in their yards in hopes of luring a willing buyer! Apparently, the practice of asking intercession from the saints is alive and well in the United States.

What is happening in the U.S. housing market is hardly unique. It is the nature of almost all markets to overshoot and then be subject to correction. It can be a painful correction for those who lose track of the difference between price and value and underlying fundamentals. As long as that correction is orderly and does not threaten the economy's financial stability, we are best advised to let it run its course, monitoring it carefully to ensure that it does not infect the rest of the economy.

We are fortunate that the rest of the economy is healthy and robust. The banking system is in good shape. There is still plenty of liquidity in the financial sector. Corporate balance sheets are strong. Investment in plant and equipment is proceeding apace. Production is being reinforced by the settling down of commodity price pressures. Consumers are getting a shot in the arm from lower gasoline and natural gas prices. And, very important, the rest of the world is growing faster than the United States, further mitigating the downside risks of a slowing U.S. economy.

Before each FOMC meeting, I talk to 30 or so CEOs and CFOs at major companies in all sectors of the U.S. economy. The perspectives of these business operators often balance the good work of our economics staff. Mind you, each of these business leaders is fully aware of the risks posed by the housing market correction. They have discounted the most likely, as well as the most grim, of housing scenarios into their planning horizons. They have adjusted their plans as GDP growth slowed from almost 6 percent in the first quarter to just under 3 percent in the second quarter and to a level probably a touch below that for the quarter that ends this coming Saturday. These business leaders are wary but nonetheless upbeat. They are confident U.S. growth will continue at a healthy pace through the fourth quarter and beyond. One of the most experienced CEOs I regularly visit summarizes it this way: "We were all expecting things to be worse, but they haven't gotten worse. We were all expecting things to get tougher, but they haven't gotten tougher."

Except in one area: procurement of labor. I am hearing more and more reports about the difficulty of finding labor to work our oil fields or run our chemical plants. Bankers complain of a paucity of bank clerks and tellers. Truckers are experiencing a shortage of drivers. In Houston, we are hearing complaints about the difficulty of finding cashiers for retail establishments. A major hotelier told me last week that there is a shortage of housekeeping staff. And for those who source abroad, finding ever cheaper inputs has become noticeably more difficult as growth in sourcing countries eats up available capacity. Having achieved a considerable amount of operating leverage from outsourcing and aggressively pushing the envelope of cyberspace, companies are now voicing the kinds of complaints about labor shortages most often heard in a full employment economy.

Several surveys of business executives have been released in the past week, all of which underscore the slower growth beginning to prevail. This includes recent surveys of the manufacturing sectors of the megastate of Texas by the Dallas Fed; the survey of the smaller but nonetheless meaningful production of eastern Pennsylvania, southern New Jersey and Delaware by the Philadelphia Fed; the National Federation of Independent Business; the Business Roundtable; and Duke University's Global CFO Survey.

Lumping it all together, I am reminded of Mark Twain's oft-quoted quip: "Wagner's music is better than it sounds." The outlook for economic growth may well be better than it sounds. At the same time, the inflation dynamic may be *worse* than it sounds.

As I sit at the FOMC table, I continue to fret more about inflation than I do about growth. While I am well aware of the risks to economic growth, the history of inverted yield curves, and the ever present possibility of exogenous shocks in a politically hazardous world, the "balance of risk," in my book, is still tilted to the inflation side of the equation. Let me give you some math to illustrate why.

The most recent Consumer Price Index (CPI) release rounded the core figure—which excludes the often volatile food and energy prices—to 0.2 percent in August, the same as July, indicating to the naked eye that inflation fundamentals were unchanged. But you have to look below the surface. Rounding can hide some underlying dynamics. July's rate was actually 0.19 percent. August's was 0.24 percent. To a normal person, this brings to mind the old saw that economists simply put two numbers to the right of a decimal point to show they have a sense of humor. But to a humorless central banker, the magic of compound interest gives meaning to the exercise and presents a different picture, one less benign than back-to-back 0.2 percent readings. On a 12-month basis, the core CPI was 2.4 percent for July. The rate for August was 2.9 percent.

August's core CPI, in other words, was midway between July's low reading and the more elevated figures of the previous four months.

Hold that thought: The latest reading of core consumer inflation was close to 3 percent, not 2 percent, measured at face value.

As you may know, the Federal Reserve Bank of Cleveland does not take the reported CPI at face value. They slice and dice the CPI to get a median measurement that some of us feel provides a more accurate picture of price pressures. The Cleveland Fed's median figure for the August CPI came in at 3.4 percent annualized. They also have a measure that lops off the most volatile and presumably least sustainable components of the CPI. For August, that number came in at 2.9 percent, which closely tracks the Dallas Fed's latest trimmed-mean estimate or 3.1 percent for Personal Consumer Expenditures inflation.

To some, 3.1 percent does not seem all that dreadful. Let me assure you that were that level of inflation sustained, it would seriously debauch the dollar. At that rate of inflation, a dollar quickly gets whittled down to cents. In 10 years, it is whittled down to 73 cents; in 15 years, it falls to 62 cents. I don't know a soul on the FOMC who would accept that kind of erosion in the purchasing power of our currency.

But, ah, you ask, didn't the Producer Price Index (PPI) that came out on Thursday exhibit considerable price restraint? Indeed it did. Excluding food and energy, it actually showed overall price *de*flation. But we must be careful not to grasp at straws here. The PPI is very "noisy" to economists' ears. Historically, it has not been very useful in forecasting consumer price inflation. Indeed, when our colleagues at the Cleveland Fed were studying the PPI a few years ago and trying to devise a way to trim out the most volatile of its components so as to get a measurement of what it showed as sustainable trends, they found they would have to trim out 90 percent of the items. It is hard to hang your hat on the PPI as an indicator of underlying inflationary trends.

So the central banker's brow, not having access to the intellectual equivalent of Botox, begins to furrow. If you are an inflation fighter, a vague recollection of Shakespeare's *Taming of the Shrew* springs to mind in Hortensio's cry, "There's small choice in rotten apples." The most reliable indicators of inflationary pressure are not yet comforting. Inflation remains elevated and leaves us small choice but to remain vigilant.

The FOMC left its monetary target—the fed funds rate—unchanged last week at 5.25 percent. I accept that decision. While the inflation risk I have just elucidated is very much on my mind, it is my considered judgment that the recent tempering of U.S. economic growth to a more sustainable rate, combined with the lagged effects of our 17 prior quarter-point rate increases, should act to lower the inflation rate over time. However, if this proves not to be the case, appropriate action will have to be taken.

Deputy Governor Elizondo will certainly agree with me that central bankers abhor inflation. It is a destructive force that erodes confidence, gnaws away at the value of money and undermines growth. In Mexico, once-chronic inflation has all but disappeared. Your country now boasts its lowest inflation in 30 years.

Neither the U.S. economy nor the Mexican can prosper unless inflation is kept under wraps. And, neither country can achieve maximum potential economic growth without the aid of the other.

Our two economies are like two ships lashed together as they navigate the turbulent seas of the global economy. As any sailor knows, when two ships are tied together, they move together. Often, it may seem as though Mexico is being towed along by the United States. I disagree. Increasingly, Mexico has become a critical part of our industrial base as a supplier of our inputs. In many ways, we are not just increasingly interdependent, we are also becoming integrated.

Nearly 90 percent of Mexico's exports are destined for the United States. And two-thirds of all foreign direct investment into Mexico comes from U.S. investors. Looked at from my side of the *frontera*, Mexico is the second largest importer of U.S. goods, well ahead of Germany, Japan and China. Mexican workers provide a significant part of the economic muscle that makes our economy so mighty. And Mexican inputs are a vital part of the supply lines of American businesses.

The numbers tell the story of our interdependency. Since 1980, the ratio of Mexico's exports to GDP has tripled, predominately fueled by sales of manufactured products to the U.S. Many of these are intermediate and capital goods, which account for almost three-fourths of Mexico's exports to the U.S. A red-hot U.S. expansion between 1994 and 2000 enabled Mexico to grow faster than any other Latin American economy. The good times came to an end in the fall of 2000, when U.S. manufacturing slowed and then stalled, hitting no country harder than Mexico. This was reversed as the U.S. economy gained steam in the ensuing recovery.

Trends in 2006 reinforce the importance of U.S. manufacturing to Mexico. Industrial production here is stout. This strength, combined with healthy growth in domestic demand, helps explain the 4.5 percent economic growth private forecasters predict this year for Mexico.

It is important to recognize that the correlation between our two nations' economies has not always been the rule. For a quarter century prior to the 1982 crisis, Mexico experienced nothing short of an economic miracle, keeping pace with Taiwan and Korea. Meanwhile, the U.S. economy in the 1970s was suffering through stagflation. You were up, we were down. When we finally emerged from our malaise in the 1980s, Mexico experienced a lost decade of economic stagnation and financial crises. You were down, we were up. The synchronization of our two nations' business cycles really only began in the 1990s. Before then, the two countries appeared to be on mostly perpendicular paths.

What changed?

Most obviously, our trade ties have strengthened. But is this a satisfactory explanation? Economists are debating whether increased trade integration alone leads to more business cycle synchronization. The debate centers on the nature of what is being traded. When trade ties lead nations to specialize in different products, their business cycles may in fact diverge. However, when trade consists predominately of goods and services within the same production stream, as is the case between Mexico and the U.S., business cycles are more likely to line up. It is no coincidence that the Mexican states that trade the most with the U.S. are the most sensitive to U.S. industrial activity.

The foreign trade and investment explosion Mexico has enjoyed over the past two decades also owes a great deal to the country's growing commitment to policy discipline.

Recent developments here, with which you are all very familiar, are indeed impressive. A recent report by the World Bank praised Mexico for its recent economic reforms, achieving the top ranking among Latin American economies for having the most improved business climate.

Prices have become more stable than ever. People can invest in Mexico without the considerable worry about inflation. An important ingredient in Mexico's success on this front was the 1994 constitutional amendment that created a *fully* independent central bank with price stability as its main goal. With a clearly stated objective and constitutional protection, Banco de México has become a no-nonsense practitioner of inflation targeting, rightfully earning the respect of the international investment and monetary policy communities.

Other policy changes have strengthened Mexico's economy and reduced its vulnerability to financial crises. Fiscal responsibility and low budget deficits have brought well-deserved praise. This has enabled Mexico to greatly improve the composition of its debt. The government ran into trouble a decade ago in part because most of its debt was in foreign hands, dollar-denominated and short-term. In 1994, 85 percent of Mexico's public debt was held outside the country. Today, the ratio is 40 percent. Emblematic of the effort to rely more on domestic sources of finance is the fact that Mexico was able to retire all its Brady debt three years ago, becoming the first country to do so.

At the same time, Mexico now borrows on better, longer terms than 10 years ago. In 1995, Mexico didn't even have a yield curve. There was no market for Mexican bonds with more than a year to maturity. Recently, however, Mexico successfully issued 20-year fixed-rate, peso-denominated bonds, and the Ministry of Finance has announced it would start issuing 30-year bonds in the fourth quarter—a truly marvelous accomplishment.

Another important policy change involves exchange rates. I certainly don't have to tell anyone in this room about the costs of past attempts to maintain a fixed currency value. A free-floating peso has helped Mexico's economy adjust gradually to shifts in foreign trade and investment, preventing the buildup of the pressures that eventually show up as a sudden shock.

Given all this progress, Mexico's financial markets have proven remarkably resilient during this turbulent election year. Past elections have given investors reason to be wary. The track record hadn't been impressive as presidential transitions often sparked financial turmoil in Mexico as the change in power presented opportunities for new leaders to reconsider past commitments. In this election cycle, there have been few signs of investor anxiety, a testament to the new stability of Mexico's fiscal house.

Gone are the days when my predecessors at the Federal Reserve or other analysts would warn of Mexico's vulnerability to financial shocks. Today, concern focuses on the absence of badly needed structural reforms that would encourage long-term growth and competitiveness.

The list of needed reforms is well-known, and you hardly need a gringo to elucidate them. You would probably agree with me that Mexico would benefit tremendously from improvements in educational infrastructure and labor reforms. The economy could also use better enforcement of property rights and more effective tax laws. Implementing these reforms is the greatest challenge facing the new presidential administration.

Critics of mine might venture that in my enthusiasm for Mexico I tend to gloss over the problem of corruption, which remains nettlesome for both Mexican citizens and foreign investors. I am well aware of it. Indeed, one of my favorite Cantinflas films was *El Señor Fotógrafo*. You may not remember it. The plotline concerns government corruption and, of course, with Cantinflas involved, the bad guys were routed in a highly comedic but determined fashion. I have high hopes that the example of a virtuous and independent central bank and other institutional reforms that have been put in place by the past two presidential administrations will continue the determined process of routing out corruption.

It would be un-Texan of me not to conclude with some words about my state and our unique relationship with the states of Mexico. If the Mexican and U.S. economies are joined at the hip, that would make the Texas economy the hip bone. Few U.S. states benefit more from Mexican purchases than Texas. The United States exported $120 billion in goods to Mexico in 2005, 42 percent of which were exported by Texas. Only 15 percent came from California. Overall, Texas exports grew nearly 4 percent in the second quarter of this year, following 5 percent growth in the first quarter. Texas is now the largest exporting state in the U.S., in no small part thanks to Mexico.

For most of its history, the Texas economy has grown faster than the United States as a whole and continues to do so today. This is to Mexico's benefit.

Even as the signs point to a slowing U.S. economy, Texas remains a shining star. In 2005, Texas gross state product increased at a rate of 4.3 percent, compared with 3.2 percent GDP growth for the U.S as a whole. We are adding jobs almost twice as fast as the rest of the country. Texas employment growth has been spread across many sectors, with almost all outperforming their national counterparts.

Significant to Mexico is the fact that the Texas construction industry is growing strongly. In the first quarter of 2005, our construction employment grew at an astounding 11.5 percent pace, followed by a 3.4 percent pace in the second quarter. Our latest reading from July and August suggests a 9.4 percent annual rate. Compare these growth rates to 4.3 percent for the construction industry across the rest of the U.S. in the first quarter and essentially no growth since then.

As real estate markets undergo a price correction across the country, our markets have not slowed nearly as much. On the whole, home sales have yet to turn downward in Texas. We are aware of the rising delinquency rates Texans are accruing on their mortgages. Only some of this is due to an oversubscription to those creative financing products I discussed a few minutes ago; mostly it is a result of high leverage coupled with slower appreciation. We do have an increasing inventory of new homes for sale, but the existing home market remains healthy, with increasing sales and some modest price gains.

As a whole, U.S. industrial production posted a 4.6 percent annual growth rate at last count. As you will see when we release the Dallas Fed's Texas Manufacturing Outlook Survey shortly after I conclude this speech, Texas manufacturing activity remains strong, with general business conditions and planned capital spending continuing to improve. Many factories are reporting increased production and healthy capacity utilization and volumes, although slightly less than what we were seeing a month ago. This should encourage you, particularly, for it implies continued prosperity for Mexico's maquiladora sector. Employment in the maquiladoras all along your side of the border grew at an annualized pace of 9.4 percent last June, adding 37,800 jobs over the prior year, with an even more impressive pace among the towns closest to the Texas border.

Estimados Amigos, me da mucho gusto estar aquí en Monterrey acompañado de Ustedes. Gracias por la oportunidad de hablarles sobre el tema de la economía de nuestros países. Como ya saben, México tiene un lugar muy especial en mi corazón. Y yo estoy seguro que, apoyándonos uno al otro, juntos podemos lograr un gran futuro. Como miembro del Comité Federal de Operaciones de Mercado Abierto de los Estados Unidos, espero poder trabajar con el Banco de México y con todos Ustedes, para asegurar un mejor futuro para nuestros hijos, tanto Mexicanos como Tejanos y Americanos. Gracias por su paciencia.