

The U.S., Mexican and Border Economies

Remarks before a Federal Reserve Bank of Dallas Community Luncheon



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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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It is an enormous pleasure to be back in Laredo. I spent a great deal of time here in 1993 and 1994, when I strayed from the path of righteousness and made a feeble run for the U.S. Senate. Wading into the cold and brackish waters of politics can be a gloomy experience, but there are rays of bright sunshine that provide a lifetime of warm memories. One of the brightest rays in my mercifully brief political career was Laredo.

I recall most fondly the Washington's Birthday Celebration weekends. I loved it when the powers that be here selected Ann Richards as *Mr. South Texas*—a deft touch that showed Laredo manages to combine respect for tradition with a cutting-edge sense of modernity, and do it with sass *en broma*. And I loved the splendor and pageantry of the Colonial Ball, with all those beautiful young women in those magnificent and phenomenally expensive dresses.

I am not the first and certainly won't be the last to be overwhelmed by the generosity of the big-hearted people of this dynamic border city, including that of our remarkable director from Laredo, Memo Trevino. I see many friendly faces here today, including Rosanne Palacios and Alberto and Lucy Cardenas, among so many others. Alberto and Lucy are the parents of Beto. Beto drove me around and traveled with me during my Senate campaign against Kay Bailey Hutchison. That was 13 years ago. Today, Beto works for Senator Hutchison, proof that time really does heal all wounds.

Having just mentioned the Colonial Ball, I can't help but single out the LaMantias. Steve and Linda have five precious girls. It was not for nothing that after the birth of Molly, the fifth daughter, Steve's dad, Joe, gave the family a dog named Boy. In the back of his mind, Papa Joe was likely discounting the future cost of five dresses for the Colonial Ball. And as true as my friendship is for the LaMantia family, he knew it would have been a bit much for me to argue for loosening monetary policy in order to accommodate outfitting those five LaMantia girls.

I want to start today with a few observations about the U.S. economy before turning to the subject of Mexico and our border economy. I remind you that, as always, I speak only for myself and neither for the Federal Open Market Committee—the FOMC—nor the Federal Reserve System.

The Current Predicament of the U.S. Economy

In recent weeks, we have heard much about financial market turbulence. We've been distracted by the noise of the subprime fallout, periodic reports of a "seizing up" in asset-backed commercial paper markets, volatility in the stock market and tremors in other parts of the financial infrastructure. (Apparently it is no longer true that, as Andrew Mellon once famously quipped, "Gentlemen prefer bonds.") Amidst this clamor and drama, some might have lost sight of our economy's great resiliency. In the first quarter of 2007, U.S. GDP rose despite sharp declines in housing and automobile production. Then second-quarter growth rebounded to a 4 percent annual rate, which is considerable for a \$13 trillion economy; in the second quarter alone, Americans produced \$130 billion in incremental output. Much of the renewed strength

came from net exports benefiting from a still-growing, historically dynamic global economy, a reminder that our flexible, highly diverse economy has many sources of growth. With a solid second quarter and low unemployment, the U.S. economy entered the second half of the year with good forward momentum. Given the financial turmoil that began last month, I am generally encouraged by what I have heard and seen so far: As yet, tighter credit conditions do not appear to have had a major impact on overall economic activity outside of real estate.

As we approach the upcoming session of the FOMC, each of the participants, including me, is diving deep into the data and taking soundings from business leaders, bankers and others with operating ears to the ground to ascertain the current pace of the economy and—this is important—the prospective dynamics of growth and inflation. I am particularly active on this front. Before each meeting, I speak with around 30 CEOs and CFOs of a careful selection of large and small companies from around the country in order to get an in-depth understanding of the pace of economic growth and price pressures they see through their businesses. Meanwhile, our staff routinely surveys a broad base of businesses within our district and reports their findings in what is known as the Beige Book, the most recent of which was released last Wednesday. Lately, I have focused on how recent developments in financial markets are impacting the revenues and costs, supplier and customer dynamics, product mix and growth projections of these hands-on operators of our economy. I am only partway along in studying the entrails of the Beige Book and a third of the way through my CEO and CFO conversations and have not yet reached any conclusions. However, it is fair to say that I am encouraged by what I have heard against a background of constant negative speculation and the occasional discordant note, such as last week’s employment numbers. Our economy appears to be weathering the storm thus far. The future path of that storm and the appropriate policy course, however, are still to be determined.

At a recent Jackson Hole retreat for central bankers and economists, Ned Gramlich, a much-revered and very wise former Fed governor who sadly succumbed to leukemia on Wednesday, reminded us in a speech that America’s economic progress has been punctuated with booms and busts. The 19th century had its canal, railroad and mineral booms. The 20th century had its rushes of financial innovation and new technology. Each boom was followed by a collapse when prices could no longer keep up. “When the dust clears,” Gramlich wrote, “there is financial carnage, many investors learning to be more careful next time, but there are often the fruits of the boom still around to benefit productivity.... The canals and railroads are still there and functional, the minerals are discovered and in use, the financing innovations stay and we still have the Internet and all its capabilities.” The fruits of the subprime market boom, he reminded us, are the millions of low-income and minority borrowers who now own their own homes and are successfully making their payments and building equity for the future.

Keep this in mind as the housing market corrects and the new financial instruments spawned by the housing boom and turbocharged financial technology continue seeking more rational price levels—levels that will be determined not by ersatz valuation models and unsustainable return assumptions, but by the market’s discipline in equilibrating supply and demand. A great many families who would never have had access to the ultimate fruit of the American harvest—homeownership—were able to achieve that dream because of the housing boom.

And what about the “bust” side of the equation, what Gramlich referred to as the “financial carnage”? I managed a hedge fund for 10 years before selling my interests in 1997, as I wound

up a banking and asset-management career that had started in 1975. I know from experience that markets are manic-depressive, subject to enormous mood swings. They overshoot on the upside in periods of enthusiasm and on the downside when reality sets in. During the inevitable corrections, there are always cries of anguish—and no paucity of self-serving policy recommendations—from financial market operators who exploited a boom and then let complacency or greed get the better of their judgment. Reward is commensurate with risk, and risk is a double-edged sword. I do not believe the Federal Reserve’s job is to protect specific risk takers who failed to protect themselves from potential downside wounds. The Federal Reserve’s job is to protect the system itself. My colleagues and I take that responsibility very seriously.

People always ask what guides me when I sit at the Federal Open Market Committee table. The FOMC is a deliberative body, and monetary policy is a judgmental business in the end. It is a complex and serious business. To live up to what is expected of us, we have to make considered judgments and not react to the latest data point or the “instant analysis” that is ubiquitous on the Internet or in the news media or among the countless financial analysts who pump out commentary like water from a fire hydrant. “Instant analysis” is a wonderful oxymoron—a true contradiction in terms, like “jumbo shrimp” or “funny economist”—but hardly the stuff of serious deliberation.

What guides me at the table is pretty straightforward. One of my four children is here today, my son Miles. Whenever I sit at the FOMC table, I am mindful that the entire transcript of our deliberations will be released in five years. I think about what Miles and his brother and sisters will think when they read their father’s words in a historical context, removed from whatever the press and the markets may be clamoring about at the time of the meeting. I am guided first and foremost by a desire for my children to be proud of their dad; to be judged by them as well as by economic historians as having been wise rather than too smart by half, as having a steady hand rather than an itchy trigger finger. I set aside the passions of the moment and the conventional wisdom in the markets and keep a steady focus on the Fed’s mission: To conduct monetary policy so as to achieve long-term, noninflationary economic growth for the great capitalist machine that is the United States of America. Conducting monetary policy is not a popularity contest.

All of this is a long way of saying that, in my humble opinion, the standard tools of monetary policy are insufficient, by themselves, to deal with the subprime market fallout. The best course, as Ned Gramlich reminded us, is to minimize the future threat to the economy while taking care not to strangle financial innovation and its benefits. He reckoned that over half the subprime mortgage loans in recent years were made by independent lenders who were not subject to federal supervision. Virtually all prime market loans, by contrast, are made by federally supervised banks and thrifts or their affiliates. Gramlich pointed out that “[i]n the prime market, where we need supervision less, we have lots of it,” whereas “in the subprime market, where we badly need supervision, a majority of loans are made with very little supervision.”

My guess is that a great deal of the potential dislocation resulting from corrective reactions to the subprime boom will be resolved by regulatory initiatives rather than by monetary policy. Yet it is important to remember that regulatory reforms are like a vaccine—better at preventing sickness than at curing it. Much of the solution for the current pathology lies in the curative workings of the financial markets. I suspect the markets will be unsparing in their treatment of the most

egregious of those who engaged in risky financial behavior. There is little that regulation can or should do to interfere with letting that treatment run its course.

Any new regulations that might now be crafted to prevent future recurrences must be well thought out, for two reasons. First, financial institutions will quickly adapt to defeat any regulation that is poorly designed, morphing into new, vaccine-resistant strains. Second, heavy-handed regulations are sometimes worse than the disease against which they are meant to protect. I would be wary of any regulatory initiatives that interfere with market discipline and attempts to protect risk takers from the consequences of bad decisions for fear of creating a moral hazard that might endanger the long-term health of our economic and financial system simply to provide momentary relief.

On that happy note, I want to shift the focus of my remarks today and comment on the U.S.–Mexico economic relationship.

The Mexican Economy

Here on the Texas–Mexico border, you are used to paying as much attention to Mexico as the U.S. I do, too, in no small part because of my personal history. The country provided refuge to my immigrant parents between 1939 and 1947 as they waited to become U.S. citizens. Two years after I was born in Los Angeles, we were off to Mexico City, where I was educated through primary school and developed a love for all things Mexican. Apart from my sentimental childhood attachment, my economic perspective on Mexico was forged in part by the four years I spent as deputy U.S. trade representative in the Clinton administration, negotiating with Mexico on the implementation of NAFTA. Back then, the official coordination of infrastructure issues, regulations and other policies needed to maximize the gains from free trade was done between the nations' capitals. But I never forgot that the cities and towns along the border, from the mouth of the Rio Grande to San Diego's beaches, were, and continue to be, ground zero for the economic integration of Mexico and the U.S.

I like to say that Mexico and the United States are joined at the hip, especially when it comes to the two nations' economies. Three-fifths of Mexico's imports, most of which are manufactured goods, are from the U.S., and two-thirds of all foreign direct investment into Mexico comes from U.S. investors. More than 90 percent of Mexico's exports are destined for the United States. Mexican workers provide a significant part of the economic muscle that makes the U.S. economy so mighty, and Mexico is a critical part of our industrial base, feeding the supply lines of American businesses. It is, therefore, vitally important for the Dallas Fed to keep a watchful eye on the economic goings-on of its southern neighbor.

What are we seeing across the border? Let me speak directly to the members of the Mexican press that are here.

Despite healthy internal consumer demand supported by much-improved credit conditions, we see a Mexican economy experiencing slower growth this year, largely due to a slowdown in U.S. manufacturing and a weak first quarter. Mexico's second-quarter GDP growth picked up, however, and the rest of this year is expected to bring faster overall growth although a slowing in U.S. manufacturing, fallout from the credit markets situation or other factors such as less foreign

direct investment and further weakness in remittances could upset the more optimistic forecasts for the Mexican economy during the rest of 2007.

Recent price developments could dampen prospects as well. Consumer price inflation has been slightly above Banco de México's target range for a few months because of a run-up in commodity and food prices. However, Mexican inflation has been at historic lows in recent years, which continues to benefit workers and consumers. Inflation is an onerous tax and a disincentive to work, save and invest. In an economy plagued by rising prices, a dollar saved ends up a quarter earned, a fact that does not change if you deal in pesos and centavos. Thankfully, the Mexican economy continues to benefit under the superb leadership of Guillermo Ortíz at Banco de México. The central bank has elected to stand pat since April, anticipating that inflation is on a slow downward trend. Nevertheless, prices spiked in July, and inflation expectations among economic and financial agents may be a bit too high.

Short-term obstacles, however, are not Mexico's foremost concern. Much more worrisome is the fact that long-term growth remains hampered by persistent structural impediments. And yet the Banco de México, having used its constitutionally guaranteed independence to subdue distracting inflationary impulses and peso devaluations, has liberated President Calderón's government and the Mexican Congress to finally deal with these vexing issues.

Investments in education are beginning to pay off, but schooling is still inadequate in many parts of the country. Property rights aren't enforced as well as they should be, creating difficulties for lending and investing. The sprawling informal sector that employs more than 20 million people—from low-skilled workers to entrepreneurs discouraged by the formal sector's burdensome regulations and taxes—creates significant inefficiency. Widespread tax evasion limits Mexico's ability to raise revenue, a hurdle for needed investment in education and infrastructure. In the energy sector, production and distribution are under government control and, given Mexico's limited fiscal resources, future oil-producing capacity is a cause for concern.

The obstacles I've just enumerated in Spanish are well documented and well understood by Mexican authorities. There is no need for me to dwell on them today. It is important to emphasize the tremendous progress the country has made over the past two decades in several key areas. Mexico embraced free trade in the mid-1980s and strengthened its economic roots with its northern neighbors and got its fiscal and monetary affairs in order in the 1990s. Since then, the transformation has been remarkable. Mexico has become an open economy with a steadfast dedication to policy discipline and macroeconomic stability. Gone are the days when election-year turmoil invariably brought Mexico's economy to its knees.

Another interesting development is in Mexican financial markets. Hard-earned macroeconomic stability has brought momentous change to Mexico's once-backward financial services sector, giving birth to a dynamic industry that, after a slow start, now offers a full menu of banking and investment services and increasing lending capacity. Mexican and Spanish banks are even buying banks in Texas and other U.S. border states to tap the large and growing Mexican population living on both sides and cater to their demand for dollar-denominated accounts and other specialized services.

The next frontier for Mexico is the implementation of structural reforms. There is much debate over just what the reforms should look like. Difficult as the process may be, Mexico must redouble its efforts to implement needed reforms.

Mexico and Texas

A few moments ago, I used the image of the U.S. and Mexico being joined at the hip. If so, that makes Texas the hipbone that connects them. The border economy is unique. The combination of maquiladoras, agriculture, cross-border trade and the region's binational labor pool has let the Rio Grande Valley, Laredo and El Paso enjoy solid growth, even during slowdowns elsewhere in the U.S. and Mexico. Texas' border cities have one foot in Mexico and one foot in the U.S., with growth linked to economic conditions on both sides. The close ties to Mexico have allowed Brownsville, McAllen and Laredo to rank among the country's fastest-growing areas since 1990 in terms of population and jobs, and border unemployment rates have dropped to record lows. A large and rapidly growing labor force and low education levels, however, have meant that border wages have remained low relative to the national average. Still, there are signs of improvement. Since 2000, average wages on the border have outpaced state and U.S. wage growth. And in 2006, median hourly wages increased faster in the Rio Grande Valley than in the state or the nation.

Maquiladoras and trade-related transportation infrastructure have long been engines of economic growth along both sides of the border. Export-related manufacturers on the Mexican side have gained steadily, drawing on a constant stream of migrating workers from southern Mexico and complementary component and material suppliers on the U.S. side. While the emphasis is still industrial on the Mexican side, the U.S. side is a services economy, with retail and health care making significant gains in jobs and activity here in South Texas. Why? Job growth and a strong peso have improved the purchasing power of the Mexican consumer. Texas' proximity to Monterrey, Mexico's second wealthiest city, and prosperous maquiladoras along the border have also meant an increase in shopping trips to Texas. This is not news to anyone in this room. Between 1978 and 2001, Mexican nationals accounted for an estimated 53 percent of Laredo's retail sales.

A positive development along the border has been an explosion in its health care industry over the past 10 years. Like retail and banking, health care is a service that is in demand by Mexican nationals and by the burgeoning population of U.S. retirees in Mexico. Hospitals and home health care agencies are expanding at rapid rates and, along with growth in education and federal government jobs in Border Patrol and Customs, are providing high-paying employment to border residents.

While almost all Texas border cities have deep ties with Mexico, their linkages can be quite different, and their economies respond accordingly to changing conditions in Mexico. Our research has found that, typically, sharp declines in the peso result in economic downturns in Laredo, McAllen and Brownsville. Each has retail sectors that depend heavily on Mexican shoppers, so swings in the peso can have big impacts. The strong and stable peso—thanks to the 1994 constitutional reform that gave Banco de México the independence it has so ably applied in recent years—is a big piece of the puzzle that explains robust growth in Laredo and the Valley.

The outlook continues to be favorable for border population and job growth, both in Texas and the states to our west. Real progress, however, will require greater productivity and increased wages. The ultimate source of income growth and prosperity originates with human capacity and education, the development of which should be the highest priority of this community. It should be the highest priority of this state.

Education and Immigrants

We never know enough in today's world and must embrace lifetime learning to achieve the American Dream. Our chief economist at the Dallas Fed, Mike Cox, likes to say, "You earn what you learn." The U.S. economy today is far different from the one that employed our parents and grandparents in the fields and factories. Agriculture represents 2 percent of our national economy. Manufacturing employs only 11 percent of our workforce. Construction and mining represent 5 percent. Eighty-two percent of American workers are employed in services, a sprawling sector that includes some of the nation's most prestigious and highest-paying jobs.

My friend Stanley Fischer, governor of the Bank of Israel, once quipped that "there are three kinds of economists: those who can count and those who can't." Yet even mathematically challenged economists are united on this: Education pays off. There is an irrefutable positive link between education and income. Wages are low on the border because education levels are low. We see this link across states, across countries, between individuals and in America's progress over time.

Spending on education is an investment in our children. But that takes time, and we in Texas and the U.S. have meanwhile added to our intellectual capital in another way. We import educated workers from other countries and do what we can to retain foreign students who come to study here. Along the U.S.–Mexico border, you know this well. Throughout its history, the region has benefited from tapping the human capital of northern Mexico's border states, which have some of Mexico's finest universities.

Let me give you an example of the "you earn what you learn" principle from our San Antonio branch board of directors. To do so, I am going to embarrass Dr. G. P. Singh, who is an American success story, combining education with entrepreneurship. As a boy in his native India, G. P. studied diligently, earning a spot in the Punjab Engineering College. Like so many foreigners, he continued his education in the U.S., earning a doctorate at Drexel University. In time, Dr. Singh came to San Antonio and started his own engineering business—Karta Technologies—a company he just sold for a cool \$65 million.

Dr. Singh's is a perfect example of how immigrant-founded firms are furthering the technological prowess of the U.S. economy. According to a recent study by researchers at Duke University and UC Berkeley, immigrants were listed as inventors or co-inventors on 24 percent of all U.S. patent applications in 2006, up from only 7 percent in 1998. Of all the science and technology companies established in the United States between 1995 and 2005, 25 percent had at least one foreign-born founder.

Most important, G. P. is a case study of how to convert learning to earning and how to harness the brain to create economic prosperity. We must foster conditions that allow a child from Laredo—or from any other city in Texas or the U.S. or from Mexico City or Nuevo Laredo or

from Punjab in faraway India—to succeed in the economic promised land called America. With a well-educated workforce, no market correction, no interruption of the orderly working of financial markets and no apocryphal prognostication of the “instant analysts” or even of humorless economists can dislodge us from our position as the world’s mightiest economic machine.

With that, I will end today’s sermon.

And now in keeping with Federal Reserve tradition, I would be happy to not answer any questions you might have.

Andamos, pues. Thank you.