

The U.S.–Mexico Economic Relationship and a Discussion of U.S. Monetary Policy

Remarks before the Asociación de Bancos de Mexico



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Thank you for having me here today at the Asociación de Bancos de Mexico.

Mexico is a very important partner to the United States, and there is a long history of close relations between the Federal Reserve Bank of Dallas and the Banco de México as well as with the broader leadership of Mexico. In particular, I would like to thank Agustín Carstens for his warm hospitality and outstanding efforts to build a strong relationship with the Dallas Fed over the past several years.

As most of you know, the Dallas Fed is one of the 12 regional Federal Reserve Banks in the United States. We represent the Eleventh District, which is comprised of Texas, northern Louisiana and southern New Mexico. This territory includes 74 percent of the 1,933 miles that comprise the U.S.–Mexico border.

As you probably also know, Texas is the largest exporting state in the U.S., and Mexico is our number one trading partner.¹ A majority of Texas immigrants come from Mexico.² In addition, cross-border investment is a key element of economic development in our region. So, building our relationship is critically important—which is why I am very glad to be here today and why I look forward to working with you for many years to come.

Today, I would like to talk briefly about the close ties between Mexico and the United States. I would then like to discuss my assessment of economic conditions as well as the appropriate role of monetary policy in addressing key economic challenges we face. Then, I look forward to taking your questions.

The Mexico–U.S. Relationship

Trade

Since the implementation of NAFTA (North American Free Trade Agreement), trade between the U.S. and Mexico has grown from approximately \$159 billion in 1994 to over \$532 billion in 2015. According to U.S. government estimates, approximately 45 percent of this represents U.S. exports to Mexico, and the remaining 55 percent represents imports from Mexico to the U.S.³ Approximately 81 percent of Mexico’s exports in 2015 went to the U.S.⁴

Increased bilateral trade and production sharing between the U.S. and Mexico has resulted in stronger economic integration, rising foreign direct investment and increasing business-cycle synchronization. For example, estimates indicate that approximately 40 percent of content in U.S. imports from Mexico originates in the U.S.⁵

As I mentioned earlier, Mexico is the number one destination for Texas exports. In 2015, Texas exported approximately \$92.5 billion of goods to Mexico.⁶ Dallas Fed research indicates that trading collaboration with Mexico has materially improved Texas' global competitiveness.⁷

Today, many Texas border cities benefit from increased U.S.–Mexico economic integration. Roberto Coronado is head of the El Paso branch of the Dallas Fed and has done extensive work trying to better understand this economic integration. His research suggests that growth in manufacturing activity in northern Mexico has generated substantial job growth in border cities such as El Paso and McAllen.⁸ Job gains have been concentrated in services and transportation, resulting in better wages and improved standards of living for Texas border residents.⁹

Immigration

The U.S. is home to more immigrants from Mexico than from any other nation—approximately 12 million. Mexican-born immigrants account for 27 percent of all immigrants living in the U.S. and 55 percent of immigrants living in Texas.¹⁰ Immigration has contributed substantially to labor force growth in the U.S. and Texas. It is estimated that immigrants and their children have comprised more than half of the growth in the labor force in the U.S. over the past two decades.¹¹ In Texas, foreign workers overall are estimated to have comprised over 40 percent of workforce growth between 1990 and 2010.¹²

Pia Orrenius leads our effort to understand immigration as well as broader economic conditions in the Eleventh District. Dallas Fed research indicates that highly skilled immigrants are substantially beneficial to the U.S. economy.¹³ Related research suggests that these workers tend to patent at much higher rates than similarly educated natives, hence contributing disproportionately to innovation and productivity growth.¹⁴ Further, immigrants tend to be more entrepreneurial than natives and have somewhat higher rates of self-employment.¹⁵ Pia's research suggests that, on average, Mexican immigrant education levels are rising, and increasing numbers are filling high-skilled jobs in the U.S.¹⁶

One further insight from Pia's work is the fact that Mexico–U.S. migration has slowed since the Great Recession.¹⁷ Net immigration flows between the two countries have been running close to zero over the past several years. This slowdown appears to have been driven primarily by improving economic conditions in Mexico relative to the U.S. In addition, the increase in dual-earner households, smaller average family size, the creation of a more substantial social safety net, as well as stronger domestic labor market prospects in Mexico have all worked to reduce the flow of migration to the U.S.

I look forward to talking more about these subjects in the Q and A. But now, let me turn to a discussion of economic conditions in the Eleventh District as well as the U.S.

Discussion of Economic Conditions

Energy

Let me begin my remarks by talking about energy, given its importance to the Eleventh District and Mexico as well as the United States. As you know, energy prices have substantially declined since June of 2014. This weakness has certainly created economic headwinds for Mexico as well as the Eleventh District economy.

At the Dallas Fed, we continue to believe that global oil production and consumption will get into rough balance by sometime in the first half of 2017. This balancing process could be helped if there is a more explicit agreement worked out between OPEC nations to limit production levels.

While there are varying estimates of the timing of reaching balance, we believe that the overall trend is the key—we are moving towards balance. Our analysis is based on our expectation that global supply will grow at a slower rate and that daily demand will continue to grow, on average, at approximately 1.3 million barrels per day for the remainder of 2016 and in 2017.

This balancing process has been more painful and slower than some had anticipated. While average daily U.S. oil production has declined by as much as 1 million barrels over the past year, these declines have been more than offset by production increases in Saudi Arabia, Iran, Russia and other countries. As a result of these developments, global oil supply reductions have been slow to materialize, and excess inventories of oil products now stand at record-high levels.

As we look ahead to 2017 and 2018, we expect to see continued price volatility. However, as we move toward balance, we expect to see excess inventories begin to decline and prices continue to firm. Despite this firming, we expect to see more bankruptcies, restructurings and merger activity in the energy sector in the U.S. Based on our energy surveys and discussions with market participants, rig count is unlikely to increase significantly in the U.S. until prices rise to between \$55 and \$65 per barrel.

The Eleventh District

The energy sector as well as a stronger dollar have created headwinds for our district. The rate of job growth in Texas for the first half of 2016 was just below 1 percent. We saw continuing job losses in energy as well as weakness in the state's manufacturing sector and slowing growth in its service sector. However, as the headwinds from energy and the dollar have begun to subside, we are beginning to see faster growth. In this regard, we now expect to see approximately 2 percent job growth in the second half of 2016 as well as in 2017.

Texas continues to benefit from migration of people and firms to the state. Population in Texas stood at approximately 27.5 million in 2015 versus 22.8 million in 2005.¹⁸ We expect this trend to continue in 2017 and beyond.

The Nation and World

GDP growth in the first half of 2016 was a disappointing 1.1 percent.¹⁹ Underpinning this weak growth was the financial turmoil in the first quarter of this year as well as a sizable inventory

deceleration in the second quarter. Initial estimates of third quarter GDP growth show an improvement to 2.9 percent. Based on these estimates and our confidence in the strength of the U.S. consumer, we now expect full-year 2016 GDP growth of approximately 2 percent.

The October employment report showed a headline unemployment rate of 4.9 percent. Additionally, the October labor force participation rate stood at 62.8 percent versus 66 percent in 2007.²⁰ We at the Dallas Fed believe that much of this decline is due to changes in demographics—that is, workers are aging out of the labor force. This trend is expected to continue in the U.S. as well as almost all advanced economies. For example, within the next 10 years, we expect the participation rate to fall below 61 percent if no mitigating actions are taken. This trend has significant implications for potential GDP growth.

Regarding inflation, our Dallas Fed economists track headline inflation and other measures of core inflation including the Dallas Trimmed Mean PCE inflation rate. This measure trims out outlying price movements. It has been running consistently at 1.7 percent since the start of 2016, up from 1.6 percent in 2015. The stability and trend of this measure gives us confidence that the headline inflation rate should gradually reach our 2 percent target in the medium term. Progress in reaching this objective has been frustratingly slow over the last few years.

In assessing economic conditions in the U.S., my research team is closely monitoring economic developments outside the U.S. to assess how these developments might impact economic growth domestically. In this regard, we are closely watching the impact of BREXIT on the U.K and European economies as well as monitoring the risk of contagion. At this stage, I believe that the impact of BREXIT is likely to be very manageable for the U.S.

Our Dallas Fed research team is also monitoring emerging-market countries, particularly China. China has a high degree of overcapacity (particularly in state-owned enterprises), high and growing levels of debt, and is in the midst of a multiyear transition from being a manufacturing- and export-driven economy to one that is based on consumer spending and services. We think this transition is likely to take many years, and the world is going to have to become accustomed to lower levels of Chinese growth. This deceleration coupled with high levels of debt is likely to make financial markets more vulnerable to periodic bouts of financial turmoil, which have the potential to tighten global financial conditions.

Broader Secular Trends

In addition to monitoring key cyclical trends in the economy, I am also closely monitoring more persistent secular drivers, which help explain shorter-term economic results. I am particularly focused on four key drivers:

- Aging demographics in the U.S. and across major economies which, on balance, will reduce labor force participation rates and create headwinds for potential GDP growth.
- The end of the so-called debt super cycle. Meaning that countries will not be able to boost debt to GDP to generate future economic growth. For example, China has been increasing its overall leverage rather dramatically, and there are questions regarding the sustainability

of this approach. In the U.S., while household balance sheets have improved, government debt to GDP has grown, and the present value of future unfunded entitlements is now estimated at approximately \$45 trillion.²¹ At a minimum, high levels of debt to GDP, along with political polarization, have constrained fiscal policy as a tool of overall economic policy.

- Globalization. Economies and financial markets are more closely intertwined than ever before. This means that events in one country can much more easily impact economic and financial conditions in other countries. The first quarter of this year was a good example; currency devaluation in China and a steep market sell-off transmitted to a rapid tightening of global financial conditions, which threatened to slow underlying economic growth.
- Disruption. Most industries are facing a disruptive competitor who is offering lower-cost goods or services. This disruption is often technology-enabled. Think Amazon or Alibaba versus retail stores, Kahn Academy versus brick and mortar schools, Uber versus taxis, and so on. Technology-enabled disruption is also helping consumers to much more easily shop for merchandise and services in a way that allows them to choose the lowest price. This trend, at a minimum, is reducing the pricing power of businesses and likely putting downward pressure on margins. This is one reason why companies have been much more hesitant to make major capital investments. One other likely impact of this disruption is on workers, which might help explain why the employment rate of prime-aged workers in the U.S. has not recovered to prerecession levels.

The Role of U.S. Monetary Policy and the Need for Structural Reforms and Broader Economic Policy

These secular trends are having an impact on economic conditions. They are, to a great extent, structural—that is, they are not easily addressed through monetary policy. This is one reason why I have suggested that, at this stage of the economic recovery, we need fiscal policy and structural reforms to join the menu of economic policy. Monetary policy is not designed, by itself, to address the key structural issues we face today. While monetary policy certainly has a key role to play, it is not a substitute for actions that address deeper fundamental challenges.

For example, given an aging population, we need to explore policies that could grow the workforce in the years ahead. This would likely involve greater emphasis on improving levels of educational attainment so as to raise the productivity of the U.S. workforce.

Options for improving educational attainment levels must include beefing up public/private partnerships that focus on vocational training that equips workers for technical and other skills-based opportunities of the 21st century. These programs could help grow the workforce and address the skills gap that has been identified by many companies we speak with in the Eleventh District.

I also believe it makes sense to consider a range of public investments that upgrade aging infrastructure and could potentially improve productivity and help to bolster sluggish demand. Given the sizable private pools of capital that exist today, some meaningful portion of this

investment could come from public/private partnerships, with substantial capital coming from the private sector.

More broadly, tax reform and regulatory policies could be considered in order to create greater incentives for capacity expansion and capital investment, which might ultimately improve future rates of GDP growth. Improved growth expectations could help to counter the forces holding down global interest rates, giving monetary policy makers greater scope for action without resorting to unconventional tools.

Some observers suggest conducting a comprehensive review of regulations at the national, state and local levels. They argue that, in some cases, excessive regulation and fees might be creating undue burdens on capital investment, lending, and the formation and growth of small business. This may help explain why business investment and small-business formation have been disappointing over the past several years.

Entitlement reforms, which involve strengthening Social Security and Medicare without jeopardizing potential benefits for those already 55 or older, could help improve the sustainability as well as ease the future fiscal burden of these programs. In addition, reforms might reduce current disincentives to remain in the labor force, while helping to soften the impact of aging demographic trends on growth and interest rates. Such reforms, insofar as they ease long-term concerns regarding the sustainability of future government debt burdens (as a percentage of GDP), might also reduce uncertainty about future tax rates and boost growth expectations through that channel.

These are some examples of policy actions that could be considered. There are certainly other examples, including efforts to implement more comprehensive trade reforms, which could help create a more level global playing field for the movement of goods and services.

Monetary policy is a key element of economic policy—but it shouldn't be the only element of policy. To improve future economic outcomes for our citizens, we need to consider structural and fiscal policies alongside sound monetary policy.

Closing

It has been a pleasure speaking with you today. I look forward to working with you in the years ahead to build the relationship between our two countries.

Now, I would be happy to take your questions.

Notes

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² “Gone to Texas: Immigration and the Transformation of the Texas Economy,” by Pia M. Orrenius, Madeline Zavodny and Melissa LoPalo, Federal Reserve Bank of Dallas, 2013, www.dallasfed.org/assets/documents/research/pubs/gonetx.pdf.

³ Census Bureau.

⁴ Instituto Nacional de Estadística y Geografía (National Institute of Statistics and Geography).

⁵ “Give Credit Where Credit Is Due: Tracing Value Added in Global Production Chains,” by Robert Koopman, William Powers, Zhi Wang and Shang-Jin Wei, National Bureau of Economic Research, NBER Working Paper no. 16426, December 2011, www.nber.org/papers/w16426.pdf.

⁶ Census Bureau.

⁷ “Texas Comparative Advantage and Manufacturing Exports,” by Jesus Cañas, Luis Bernardo Torres and Christina English, in *Ten-Gallon Economy: Sizing Up Texas’ Economic Growth*, Pia M. Orrenius, Jesus Cañas and Michael Weiss, eds., Palgrave MacMillan, 2015, pp. 159–79.

⁸ “So Close to Mexico: Economic Spillovers Along the Texas–Mexico Border,” by Roberto Coronado, Marycruz De León and Eduardo Saucedo, in *Ten-Gallon Economy: Sizing Up Texas’ Economic Growth*, Pia M. Orrenius, Jesus Cañas and Michael Weiss, eds., Palgrave MacMillan, 2015, pp. 183–97.

⁹ “El Paso and Texas Border Cities Close the Gap in Per Capita Income,” by Roberto Coronado and Robert W. Gilmer, *Crossroads*, Issue 2, 2012, www.dallasfed.org/assets/documents/research/crossroads/2012/cross1202.pdf.

¹⁰ American Community Survey 2015.

¹¹ “The Economic and Fiscal Consequences of Immigration,” National Academies of Sciences, Engineering and Medicine, 2016, p. 50, www.nap.edu/catalog/23550/the-economic-and-fiscal-consequences-of-immigration .

¹² See note 2, p. 3.

¹³ “From Brawn to Brains: How Immigration Works for America,” by Pia Orrenius and Madeline Zavodny, *Federal Reserve Bank of Dallas 2010 Annual Report*, 2011, www.dallasfed.org/assets/documents/fed/annual/2010/ar10b.pdf.

¹⁴ “How Much Does Immigration Boost Innovation?” by Jennifer Hunter and Marjolaine Gauthier-Loiselle, *American Economic Journal: Macroeconomics*, vol. 2, no. 2, 2010, pp. 31–56.

¹⁵ See note 11.

¹⁶ “Central Americans in the U.S. Labor Market: Recent Trends and Policy Impacts,” by Pia Orrenius and Madeline Zavodny, CANAMID, 2015, www.canamid.org/en/publication?id=PB03.

¹⁷ “The Real Story Behind Mexican Immigration: And What It Means for the U.S. Economy,” Pia Orrenius, 2016, www.bushcenter.org/publications/articles/2016/07/the-real-story-behind-mexican-immigration.html.

¹⁸ Census Bureau.

¹⁹ “National Income and Product Accounts, Gross Domestic Product: Third Quarter 2016 (Advance Estimate),” Bureau of Economic Analysis, Oct. 28, 2016.

²⁰ “The Employment Situation–October 2016,” Bureau of Labor Statistics, Nov. 4, 2016.

²¹ 2016 Annual Report of the Boards of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds, June 22, 2016.