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President's Perspective



The Dallas Fed has developed a tool to gauge the direction and speed of approaching inflationary winds and given it the somewhat unwieldy name of Trimmed-Mean PCE Deflator.

In 1748, when we were an agrarian society and the crown the colonies' currency, Benjamin Franklin said, "He that kills a breeding sow destroys all her offspring to the thousandth generation. He that murders a crown"—today, a dollar—"destroys all that it might have produced."

Franklin's words offer a warning against debasing our currency's value, and I carry them in my pocket as a reminder of my obligation as an inflation fighter.

Of course, we can't control inflation unless we can measure it. The Dallas Fed has developed a tool to gauge the direction and speed of approaching inflationary winds and given it the somewhat unwieldy name of Trimmed-Mean PCE Deflator.

Developed last year by senior economist Jim Dolmas, this measure takes the Commerce Department's monthly Personal Consumption Expenditures deflator and strips away both the highest and lowest price increases for categories of goods and services. The idea is to focus on underlying inflationary pressures,

while avoiding temporary volatility that might lead to faulty conclusions on the economy.

The latest trimmed-mean readings—which excluded a big price increase for owner-occupied housing and big price declines for trucks, used cars and airline tickets—suggest a base inflation rate of 2.5 percent for the past 12 months.

The trimmed mean provides a useful refinement to the PCE deflator, which since 2000 has been the Federal Reserve's main guide for tracking inflationary trends. To reveal core inflation, analysts usually set aside food and energy prices, which are often volatile due to weather and other transient conditions. The PCE deflator, excluding food and energy, was up 2.1 percent in the past year.

The Trimmed-Mean PCE Deflator has become a key component of my economic tool kit. Each month, we post updated trimmed-mean data on the Dallas Fed's web site. I encourage you to join me in using this yardstick to measure inflation.

A handwritten signature of Richard W. Fisher in gold ink. The signature is written in a cursive, flowing style.

Richard W. Fisher
President and CEO
Federal Reserve Bank of Dallas



Midyear Update: Major Metros Driving Texas Expansion

By D'Ann M. Petersen

In 2005, the Texas economy posted its strongest performance since 2000, and it remains on track for a solid showing in 2006. Most indicators point to an economy on an expansionary path through the first six months of the year, and interviews with business executives suggest broad-based strength.

Texas' major metros don't always move in tandem, nor in sync with the state's economy as a whole. Each possesses distinct attributes that determine its growth path. During the tech-induced downturn that began in 2001, for instance, the tech-intensive centers of Austin and Dallas suffered dramatic job losses, while the San Antonio, Houston and Fort Worth economies mostly held their ground.

The metro economies are currently moving in tandem—or at least in the same expansionary direction. Still, the pace of growth varies by metro. In 2005, Austin was the job-growth leader and San Antonio was close behind. Dallas trailed the two, caught in a sluggish stretch following the recession. Houston matched the state average in job creation, while Fort Worth grew at a slower pace.

Midyear 2006 numbers show Austin and Dallas in a virtual dead heat. Both cities are benefiting from a high-tech turnaround, with Dallas getting an extra boost from surging service employment. The three other major metros are slightly below the state average in job growth. In the major border metros, employment growth has been robust, largely because a strong peso has encouraged retail sales and the growing Mexican maquiladora sector has created jobs on both sides of the border.

The major metros account for roughly 71 percent of the state's employment, so their collective performance largely determines the Texas economy's path.

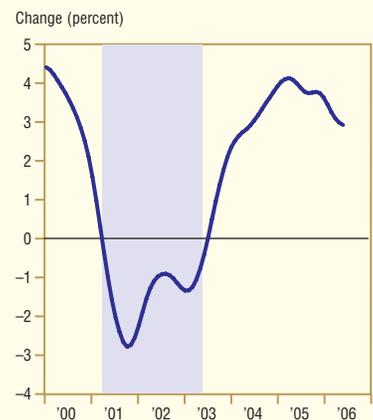
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Moving Forward in 2006

One of the best barometers of the state's underlying trend is the Dallas Fed's Texas Business-Cycle Index—a composite of indicators that include employment, the unemployment rate and gross state product. So far this year, the index has grown at a fairly strong 3.2 percent, slower than last year's 3.9 percent but indicative of an expanding economy (*Chart 1*). At the same time, Texas' per capita income has risen relative to the U.S. average, another sign of increased prosperity (*Chart 2*).

Anecdotal reports also suggest a healthy Texas economy. The Dallas Fed's July Beige Book survey of business executives reported strong activity, with a tight labor market and high demand for skilled workers. Moreover, respondents to the Dallas Fed's latest Texas Manufacturing Outlook Survey noted that industrial

Chart 1
Texas Business-Cycle Index
Stays in Positive Territory

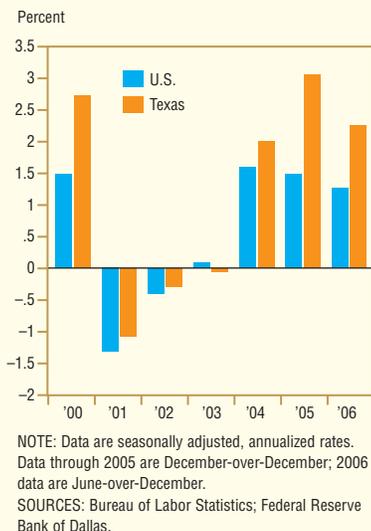


NOTE: Data are month-over-month, seasonally adjusted, annualized rates. The shaded area indicates a recession.
SOURCE: Federal Reserve Bank of Dallas.

Chart 2 Texas' Share of Per Capita Income on the Rise



Chart 3 National, State Job Growth Slower in 2006



activity continues to expand.

Despite the positive reports, 2006 employment data—which are subject to revision—show job growth slowing markedly from last year's rapid tempo (*Chart 3*). Texas jobs were up 2.3 percent the first half of 2006, building on an increase of 3.1 percent in 2005.

The upbeat Beige Book responses and other indicators of healthy economic activity suggest job growth estimates will be revised upward when more detailed benchmark data become available later this year. Texas employment statistics tend to understate job gains during expansions. Over the past five quarters, the initial estimate has been revised upward an average 1.3 percentage points. Based on current conditions, the Dallas Fed expects employment growth of 2.5 to 3 percent in 2006.

Metros Show Diversity

The state's major metros share attributes that help propel growth, such as low living costs and a welcoming business climate. Just as important in today's increasingly globalized economy, Texas sits at the center of North America, with port access, trade and distribution channels, and proximity to Mexico, its largest trading partner.

The major metros' business-cycle indexes—broad-based measures calculated using employment, the unemployment rate and retail sales—are currently moving together in expansion (*Chart 4*). But the big urban economies retain differences that affect the rate and composition of economic growth.

Austin Rebounds. The capital city experienced a remarkable comeback in 2005, outpacing the other major Texas metros in job growth (*Chart 5*). The turnaround followed a deep, prolonged high-tech bust that shrank employment from 2001 through 2003 and held back job growth in 2004. Last year's strength was partly due to a rebound in the high-tech sector. Austin's economy continues strong in 2006, maintaining its momentum with employment growth that just barely surpasses Dallas' to hold the state lead for the second straight year.

Compared with other high-tech centers across the country, Austin has advantages that are spurring relocations and business expansion. These include the low cost of living and doing business. A key factor is relatively affordable housing—a

median home price of \$167,200, compared with \$390,400 in Boston and \$746,800 in San Jose. Texas' lack of a state income tax gives Austin and other state metros an edge. Austin is also home to the University of Texas, the country's largest university, which with other schools supplies a ready workforce for the metro's growing firms.

The companies and people flocking to Austin are fueling job growth in high-tech and other sectors. Manufacturing employment has risen this year, spurred by machinery production tied to the semiconductor and computer-related industries.

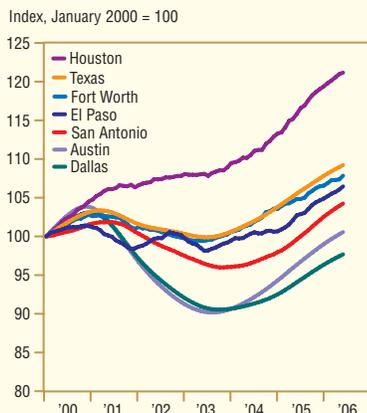
Samsung's recent announcement of a new \$3.5 billion chip manufacturing plant bodes well for continued high-tech employment growth. Other indicators point to the sector's dynamism. The June Austin Purchasing Managers Index shows manufacturing in expansion mode, with production, new orders and order backlogs growing. The metro should also benefit from U.S. high-tech production remaining in positive territory (*Chart 6*).

Austin has seen robust job growth in construction and trade, transportation and utilities (*Chart 7*). The growing metro economy is boosting construction of all types. Housing demand is at record highs, and strong sales growth is encouraging retail expansion. Several major players—Ikea, Neiman Marcus and Macy's—have scheduled store openings for later this year.

Although on the upswing, venture capital spending has yet to return to Austin in a big way. Start-up funding has revived in places like Silicon Valley and New England, but in 2005 Austin managed to raise just a fifth of what it did in 2000, according to Pricewaterhouse Coopers/National Venture Capital Association. Given its heavy reliance on semiconductor and computer-related high tech, Austin would likely benefit from further diversifying into nano- and biotechnology and related fields, thereby tapping into new forms of venture capital.

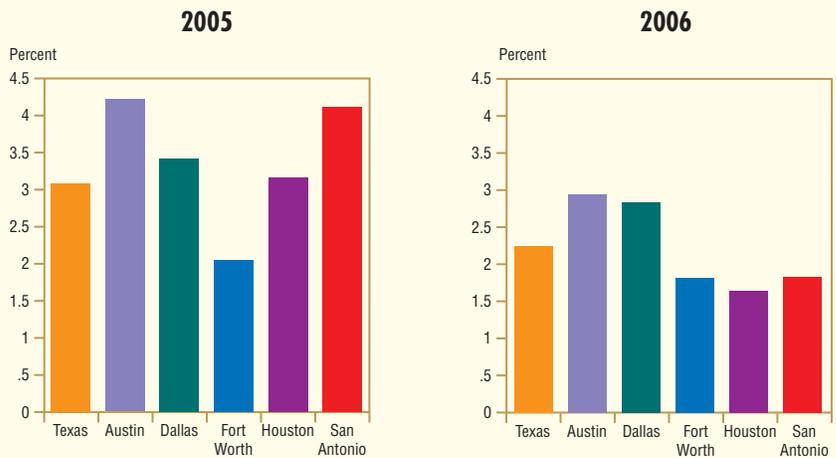
Dallas Stages Comeback. Dallas suffered mightily when the 2001 tech bust decimated one of its fastest-growing industries—telecommunications services. The reverberations sounded through the Dallas economy, causing manufacturing jobs to dry up in such industries as semiconductors and communications equipment and bringing construction activity to a standstill. While overall employment stopped falling in mid-

Chart 4
Metro Business Cycles
Moving Together



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

Chart 5
Job Growth in Major Texas Metros: Austin, Dallas in the Lead



NOTE: Data are seasonally adjusted, annualized rates. 2005 data are December-over-December; 2006 data are June-over-December and subject to revision.

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

2003, Dallas saw only tepid job growth the rest of that year and all of the next.

The Dallas economy has restructured, making way for renewed growth. The attributes that have served the city well in the past—a central location within Texas and the United States, a large global trade and transportation network, a sophisticated financial sector and a reputation for entrepreneurship—are again spurring impressive growth. After lagging other major Texas metros for several years, Dallas finally gained momentum in employment growth in 2005. This year, it nearly matched Austin, the state leader (*Chart 5*).

Dallas retains roughly 40 percent of the state's jobs in both telecom services and high-tech manufacturing; yet these sectors' combined share of the metro's total employment fell from almost 7 percent in 2000 to just under 4 percent in 2006. Although job losses in these fields have mostly leveled off, productivity increases have limited the need to hire workers. But demand for high-tech products remains strong, according to the Beige Book. Furthermore, a recent survey by the *Dallas Morning News* suggested several area telecom companies are planning to add jobs for the first time in years.

Professional and business services employment has grown at a torrid 10.3 percent in Dallas this year, eclipsing all other categories in any of the Texas metros

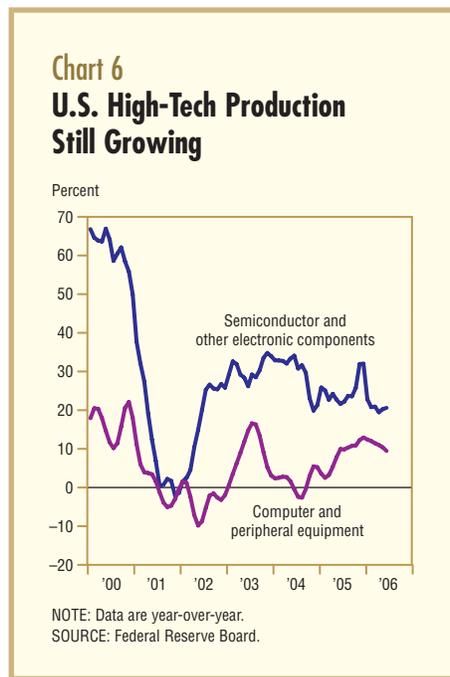
(*Chart 7*). This sector, which makes up 16 percent of Dallas' job base, includes technical and scientific professions, accounting, legal occupations, architecture and engineering, and computer design. Growth in this sector, along with financial services and health care, is boosting demand for office space.

Fort Worth on Steady Course. The Dallas and Fort Worth economies are intertwined, but Fort Worth is less volatile than its neighbor to the east. Major defense-related manufacturing firms have attracted other high-tech companies to Fort Worth, but the share of these jobs is not as large as in Dallas. As a result, Fort Worth's economy avoided the large declines that hit Dallas and grew at a pace near the state average during the most recent recession and recovery, despite significant losses in airline employment following 9/11.

Fort Worth's economy expanded moderately in 2005 and has grown slightly slower than the rest of the state in 2006 (*Chart 5*). The upbeat prospects for many Fort Worth industries bode well for steady growth. As the metroplex's global transportation hub, the city complements Dallas' huge trade industry. Dallas/Fort Worth International Airport, Alliance Airport, American Airlines and Burlington Northern Santa Fe Railway call the Fort Worth area home. The trade-transportation-utilities sector has added jobs at a solid clip this year.

The major metros' business-cycle indexes—broad-based measures calculated using employment, the unemployment rate and retail sales—are currently moving together in expansion.

With all its major metros showing solid gains, the Texas economy appears poised for continued growth the rest of 2006 and into 2007.



The leisure and hospitality industry is a major player in the Fort Worth metro economy. Six Flags Over Texas in Arlington and Gaylord Texas Resort and Convention Center in Grapevine are big attractions. The industry has seen job growth of 5 percent this year, making Fort Worth No. 1 in this category (*Chart 7*).

Construction has been one of Fort Worth's leading industries in 2006. Affordability is spurring housing demand, and the retail and apartment markets are strong both downtown and in the outer suburbs. While Dallas still has one of the country's highest downtown office vacancy rates—23 percent—Fort Worth has one of the lowest—6 percent.

Pier 1 and RadioShack have left the central city for their own campuses, but Fort Worth's office market has benefited from such downtown redevelopment as Sundance Square and the former Bank One tower's conversion to apartments. Energy firms are leasing downtown space as natural gas drilling in the nearby Barnett Shale has intensified. Job growth in professional and business services is also adding to the demand for office space.

Fort Worth's history as a leader in defense electronics is important. Lockheed Martin—along with Bell Helicopter, one of the metro's two largest employers—reports relatively steady employment, with production increases of the Joint Strike Fighter offsetting declines related to the F-16. While

job gains in defense and other tech manufacturing have been modest this year, increases in transportation equipment manufacturing are helping keep factory employment positive.

Houston Benefits from Energy. The energy sector is again pumping up the Houston economy. Despite diversifying after the oil and gas bust of the mid-1980s, Houston remains the world's energy capital, with roughly half the city's jobs tied directly or indirectly to the industry.

Houston's economy made it through the most recent Texas downturn without a major drop in employment, largely because the city relies less than Dallas and Austin on high-tech jobs. Following relatively modest job growth in 2004, the Houston economy finally picked up the pace last year, increasing employment 3.2 percent (*Chart 5*). A prime factor was a change in the way oil producers and operators view high energy prices—going from skepticism to the belief that they're a long-term factor thanks to global demand. In 2006, the Houston economy remains in good shape, with job growth in key sectors (*Chart 7*).

As expected, oil and gas extraction employment is rising, but the pace is restrained by difficulty finding skilled workers. Still, the number of drilling support jobs was up a healthy 14 percent for the 12 months that ended in June. Buoyed by demand for scientists and engineers, the professional and business services sector

has seen job growth of 5.6 percent in 2006, and construction is strong across the board. Houston finished third in the country in metro single-family building permits in 2005 and is on track to rank near the top again this year.

The Port of Houston, the country's second-busiest deepwater facility, plays a major role in the local and state economies. The Port Authority, which accounts for 15 to 20 percent of Houston's overall port activity, reported in May that shipments were up about 20 percent from the same month last year, with petroleum-related products accounting for the bulk of exports and imports.

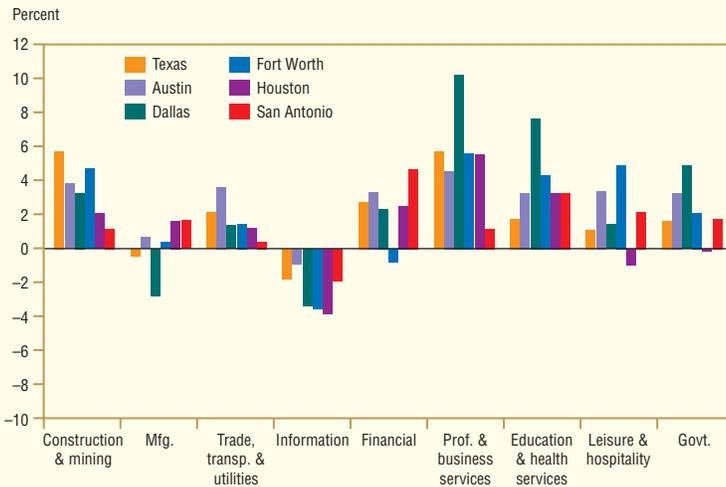
San Antonio Gains Steadily. Because of its reliance on such cyclically stable industries as the military and health care, the Alamo City's economy has historically experienced milder swings than other metros. San Antonio mirrored the state's overall performance during the recent recession and recovery, while Austin and Dallas saw large swings.

San Antonio's economy continues on a steady upward path, even though the military presence has diminished over the years and biosciences and related high-tech fields have come to the fore. In 2005, job growth accelerated to just over 4 percent, thanks to relocations and expansions in health care, financial services and manufacturing. Employment increases are more moderate this year, but most major sectors important to San Antonio's economy are still expanding (*Chart 5*).

Financial services jobs are growing at 4.7 percent, leading all other major metros, and Washington Mutual's multiple hiring announcements bode well for further increases (*Chart 7*). With the Alamo and the River Walk the state's most popular tourist destinations, the leisure and hospitality sector remains a mainstay of the metro economy. Industry employment is up moderately, and according to the Convention and Visitors Bureau, the city is on track for one of its best convention years since 2001. Employment in education and health services is climbing, and an increased focus on biotech has drawn new businesses.

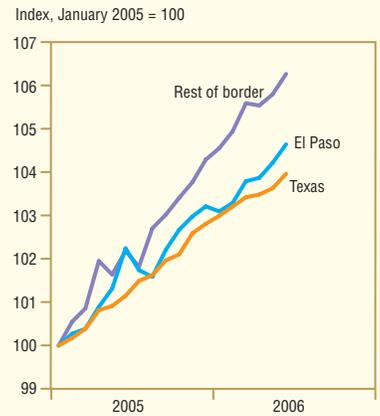
Manufacturing job growth has been modest this year, but stronger gains are expected as the new Toyota truck plant goes into production this fall and suppliers add to the workforce.

Chart 7
2006 Employment Growth Broad-Based Across Metros and Sectors



NOTE: Data are June-over-December, seasonally adjusted, annualized rates.
 SOURCES: Bureau of Labor Statistics; Federal Reserve Bank of Dallas.

Chart 8
Border Seeing Faster Job Growth Than Texas Overall



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

Even the military stands to see employment growth in 2006. Last year, San Antonio gained a satellite campus of the National Security Agency, which plans to hire several hundred employees and may attract military contractors. In addition, the Defense Department's plans to shutter bases across the country will benefit San Antonio, which will add up to 3,500 military and civilian positions. Even with the increases, the government sector would make up just over 18 percent of total employment, compared with 23 percent in 1990.

Border Cities Add to Growth. Texas' border economies, with their strong ties to Mexico, continue to be a source of strength for the state. Following rapid expansion last year, border employment growth is exceeding the state average so far in 2006 (*Chart 8*).

The exception is El Paso, the largest of the border metros, where job growth has been closer to the state average. El Paso's economy continues to move from its historical reliance on apparel manufacturing to a more diversified, service economy. In 1990, overall manufacturing made up 19 percent of total employment. Today, the share stands at almost 8 percent.

As the maquiladora sector grows just across the border in Ciudad Juárez, El Paso has converted its remaining manufacturing to smaller, intermediate-goods suppliers. The maquiladoras are boosting service jobs

in El Paso, especially professional and business services. The Fort Bliss expansion under the Defense Department's military realignment is also stimulating the city's economy.

Because of their location, border towns rely heavily on the transportation, trade and utilities sectors. They've also benefited from strong retail sales to Mexican nationals and increases in U.S.–Mexico trade. While some uncertainty exists following Mexico's divisive July election, the peso's strength and the country's economic growth should continue to boost Texas' border towns.

What Lies Ahead

With all its major metros showing solid gains, the Texas economy appears poised for continued growth the rest of 2006 and into 2007. As with any forecast, however, unforeseen factors could speed up or slow the expansion. Global demand for high-tech products will impact economic activity in Austin, Dallas and Fort Worth. San Antonio and the border metros will be influenced by the peso's value and growth in Mexico.

The U.S. economy bears watching, too. The Blue Chip Economic Indicators, a survey of top forecasters, anticipates a slowing at the national level. The consensus envisions the U.S. economy growing at

3.5 percent this year and 2.8 percent in 2007. Indeed, second-quarter GDP growth came in at 2.5 percent, considerably slower than the first quarter's 5.6 percent. Behind the slowdown are the pinch on consumer spending from higher energy prices and softening housing markets.

These factors could take some of the steam out of the Texas economy. On the flip side, the state is helped somewhat by rising energy prices. While consumers still feel the brunt, royalties help offset the pocketbook impact, and increased drilling spurs output gains, boosting Houston in particular. Texas' major metros didn't see large run-ups in home prices during the recent housing boom, and they're unlikely to see much of a bust, although residential construction could ease.

Ultimately, the metros will benefit from their individual advantages as well as their shared attributes. The state's low costs and favorable tax and government policies should continue to allow the metros to attract workers and companies from other parts of the U.S. and overseas. Their central location and expanding trade capabilities should also enable them to profit from the global economy.

Petersen is an associate economist in the Research Department of the Federal Reserve Bank of Dallas.

Making Sense of High Oil Prices

Stephen P. A. Brown, the Dallas Fed's director of energy economics, discusses the forces behind the recent surge in oil prices, the prospects for alternative fuels and the economic fallout from increasingly expensive energy.

Q: What's behind the rapid rise of oil prices?

A: First and foremost, it's a demand-driven price spiral. We've had strong economic growth in the U.S., while China, India and other rapidly developing nations have greatly increased their consumption. When added to existing needs in Europe, Asia and elsewhere, global demand has outstripped any gains in production and reduced excess capacity to near zero.

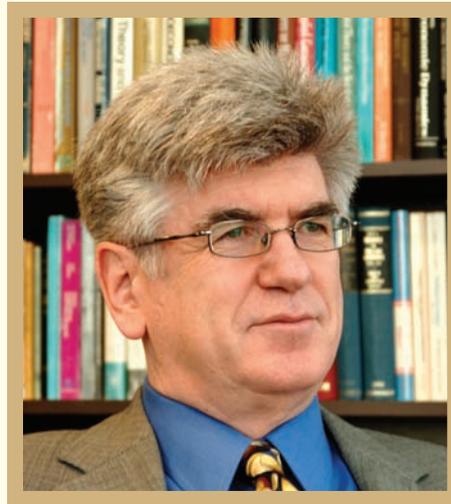
Other factors are important. Troubles in such oil-producing countries as Nigeria, Venezuela, Iraq and Iran have spurred fears of supply disruptions. The dollar has been depreciating, which means we've seen higher real price increases than Europe or Asia. The demand for oil is very inelastic, so small increments of market tightening lead to strong price movements.

The result has been a doubling of oil prices in the past few years. The weekly benchmark price for a barrel of West Texas Intermediate rose from \$32.20 at the end of 2003 to \$42.56 at the end of 2004 and to \$59.49 at the end of 2005. In early July, oil topped \$75 a barrel—an all-time high in current dollars. If we adjust for inflation, oil would have to reach \$96 a barrel to match the record set in April 1980.

Q: Do we face a future of high and rising oil prices?

A: It depends on who you ask. One group contends oil production is at or near its peak, and prices will just continue to rise with global demand. We hear this argument from oil industry veteran T. Boone Pickens and Matthew Simmons, author of *Twilight in the Desert: The Coming Saudi Oil Shock and the World Economy*.

Not everyone is so bleak. The U.S. Energy Information Administration, the



International Energy Agency and Daniel Yergin's Cambridge Energy Research Associates all see sufficient oil resources for generations to come. They expect new supplies to flow onto world markets in the next few years, knocking prices down to the \$35 to \$45 range.

Between these two extremes lies the view expressed by New York University economist Dermot Gately and others—that resources are indeed abundant, but impediments to exploration and delivery will keep prices elevated. This view is consistent with the readings in the futures market, which show oil prices remaining high through the rest of the decade. We can expect ups and downs along the way. The options market reveals considerable uncertainty about oil prices over the next few years.

Q: Are higher oil prices the main factor pushing up gasoline prices?

A: For the most part, yes, but today's retail gasoline price is about 25 cents higher than would be suggested on the basis of crude oil prices. The difference comes partly from a

shift to ethanol as the summer oxygenate and partly from the fact that gasoline prices rise more quickly when oil prices rise than they fall when oil prices decline.

Q: Are industry profits and mergers driving oil prices?

A: No. World oil markets are dominated by producing countries—not the oil companies. The big profits aren't unexpected. Anytime a company sees rapid increases in the price of what it sells, it's going to do well. When these companies were producing crude oil for \$20 a barrel, they weren't making nearly as much money. If we punish their recent success, they'll have less money and less incentive to invest, and in the end we'll get less oil.

No empirical evidence links mergers to the jump in oil prices. In fact, many of the mergers occurred before the latest spike in prices—at a time when the industry was downsizing and consolidating. Some evidence suggests, however, that mergers may have had a small effect on retail gasoline prices in cities where consumers now have access to fewer brands of gasoline.

Q: What are the prospects for increasing supplies of oil?

A: Extensive exploration and development are taking place in the U.S. and abroad, so it seems likely that new oil supplies will come on line in the next few years. The primary limitation isn't money. The companies face shortages of the equipment and personnel required to increase drilling.

Although oil producers are responding to higher prices, the gains in supply are likely to prove modest because reserves are concentrated in countries where incentives to increase output aren't strong. These are places where the government controls the oil industry or where a lack of economic freedom stifles the private sector.

Two-thirds of the oil is in Saudi Arabia, Iran, Kuwait, the United Arab Emirates and other countries with heavy government

“I estimate that the tripling of oil prices since 2002 has reduced GDP by 2.4 to 3.2 percent, spread out over a number of years.”

direction of the oil industry. Only 15 percent of reserves are in nations with high scores in economic freedom and market-driven oil production—chief among them, the United States and Canada.

The best prospect in these two countries lies in unconventional sources of supply. One is oil sands, which can be used to produce oil profitably at prices as low as \$35 a barrel. Canada has huge deposits in Alberta. The exploitation of oil sands is being increased, but not fast enough to ease the market.

Experts expect shale oil can be profitably developed at prices as low as \$50 a barrel, and these deposits are thought to be plentiful in the U.S. The shale oil projects are still consigned to the oil companies’ advanced technology groups, rather than their exploration and production divisions. Given how recently oil prices were below \$50 a barrel and uncertainty about future prices, it’s not clear when oil companies will shift from shale-oil research to shale-oil production.

Q: What about developing alternatives to oil—such as hydrogen or ethanol and other biofuels?

A: With today’s technologies, hydrogen is more like a battery that stores energy than an energy source. We have to use oil, natural

gas or electricity to produce hydrogen.

If we use oil or natural gas, we would be using fuels that are already portable to obtain hydrogen and incurring an energy loss to do so. In the case of electricity, which isn’t portable, the energy use would be massive—on the order of 15 times more than we’d get back from the hydrogen. Hydrogen does have the advantage of being a clean fuel.

With current technologies, biofuels are still fairly expensive. Ethanol also has problems when used in high concentrations. Biodiesel is attractive at current prices but limited in quantity.

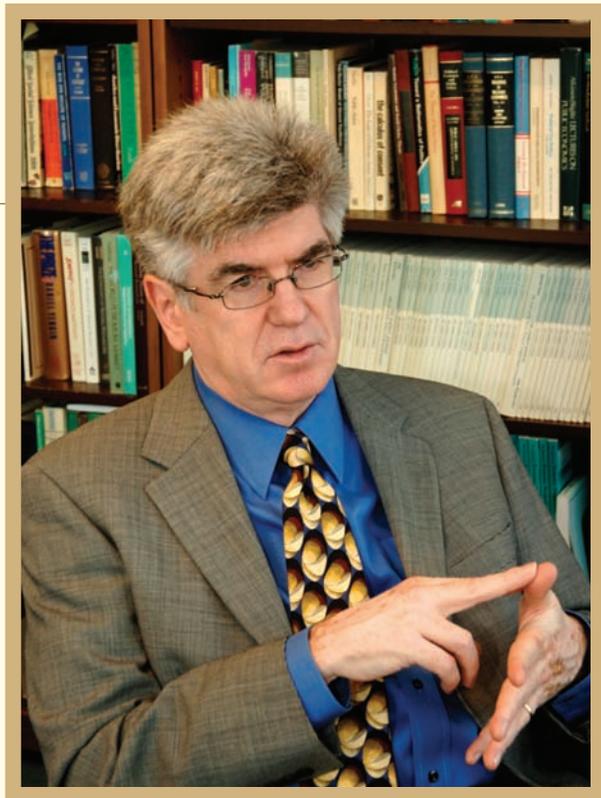
Q: What about the benefits of changes to improve fuel efficiency?

A: Three-quarters of the oil we use goes for transportation—so fuel efficiency can make a big difference. Today’s gasoline prices are encouraging people to drive less and buy more efficient cars and trucks. It takes time to turn over the fleet of vehicles, and the automobile manufacturers have to gear up to change their production mix.

Q: How are high energy prices affecting the economy?

A: Growth is slower. Inflation and interest rates are higher. I estimate that the tripling of oil prices since 2002 has reduced GDP by 2.4 to 3.2 percent, spread out over a number of years. Most of the losses are behind us now, so the losses through the end of 2007 will likely be about half a percentage point a year.

In magnitude, the inflationary ripples are on par with the decline in GDP. The lags, however, are longer. The price increases are slower to be realized and take longer to run their course. The price effects of the oil spike



are what we’re dealing with now.

With higher energy prices, the near-term loss in income is greater than the longer-term loss. As a result, consumers try to smooth their consumption over time, either through borrowing or reducing savings. Either way, interest rates are likely to be pushed upward.

Q: Why has the impact been relatively mild?

A: Unlike the sudden shocks of the OPEC oil embargoes of the 1970s, recent rises in oil prices have been driven by growing demand rather than sharply reduced supply. The result has been a more gradual increase in prices that has given the economy more time to adjust.

Over the past 20 to 30 years, we’ve become much more efficient in our energy use. In 1980, it took twice as much energy to produce \$1 of inflation-adjusted GDP as it does today. As a result, each dollar increase in oil prices has less impact. It also helps that we’ve experienced oil price shocks in the past. Firms have learned how others in their supply chains will respond.

Of course, the GDP loss can’t be eliminated completely. High energy prices are the result of energy becoming scarcer. When energy supplies are tighter, it reduces the output we get from given quantities of labor and capital.



Taking Texas Talent to a Worldwide Market

In this era of globalization, big Texas-based law firms have hung out their shingles in far-away places—Fulbright & Jaworski in Dubai, Akin Gump Strauss Hauer & Feld in Taipei, Thompson & Knight in Rio de Janeiro and Bracewell & Guiliani in Kazakhstan.

At the start of the year, Texas firms had at least 275 lawyers in 36 offices in 18 key business cities around the world, according to firm directories and *Texas Lawyer*. Many of the outposts represent recent forays overseas. Three-quarters of the foreign offices were established in the past decade. Last year was particularly busy, with the opening of 11 offices.

This tally includes only firms headquartered in Texas. Many out-of-state law firms with significant global reach maintain large operations in Dallas and Houston, among them Jones Day; Weil, Gotshal & Manges; and Baker & McKenzie. Texas firms can also serve clients' global needs in other ways—by contracting with foreign-based firms or shuttling lawyers abroad to take on specific projects.

“We’re responding to our clients going

global,” said Tim Powers, chairman of the international practice group at Haynes and Boone, which opened offices in Mexico City in 1995 and Moscow in 2005.

Trade statistics show that Texas ranks as the No. 1 exporting state, but the numbers cover only goods. No state-by-state data exist for services, a category of exports that includes travel, telecommunications and finance, as well as legal services. From 1992 to 2004, American law firms’ overseas sales tripled to \$3.9 billion.

The United States is highly competitive in legal services, and Texas lawyers say they’re at the forefront of the march abroad. The firms’ wedge has been their expertise in what is perhaps the most globalized of all businesses—oil and gas. Although existing clients provide the impetus for going overseas, law firms often find new business once they’ve established a foothold on foreign soil.

“The catalyst was representing Texas companies in China,” said Jay Cuclis, international practice coordinator at Vinson & Elkins, which last year opened an office in Shanghai, its sixth foreign outpost. “Once

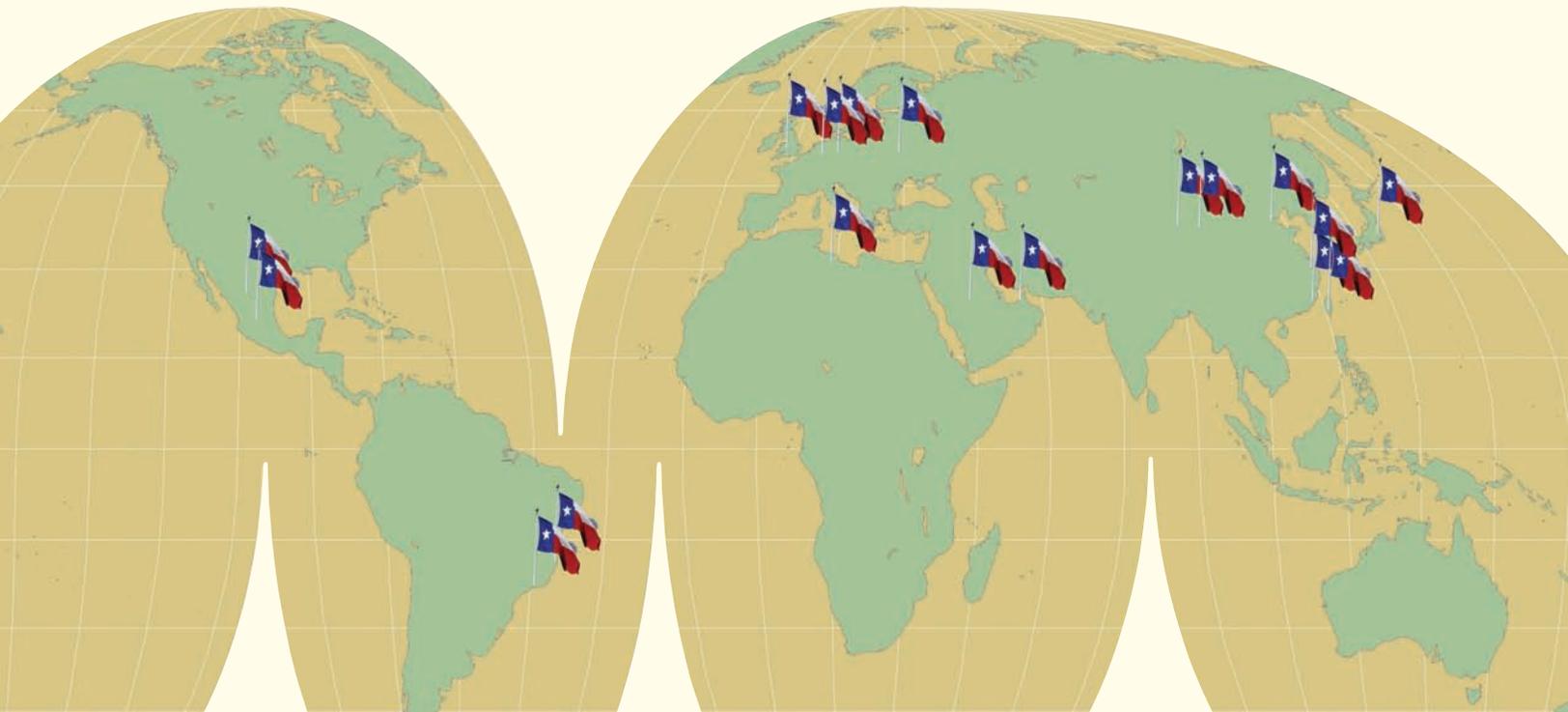
we got there, some of the Chinese energy companies came to us because of our oil and gas expertise.”

The international work involves an array of legal specialties. In addition to energy, Haynes and Boone foreign offices handle private-equity investment, project finance and arbitration for dispute resolution. In Beijing and Shanghai, Vinson & Elkins helps U.S. companies organize their Chinese operations, tackles tax issues and negotiates with the Chinese government. In Moscow, Baker Botts has advised Russian energy companies going global and helped local clients with real estate deals.

“Each year, we’ve become more international in all our practice areas,” said Stuart Schaffer, who leads the global projects group at Baker Botts.

In the next few years, the Texas flag is likely to be raised on more law offices abroad. Baker Botts has asked Chinese authorities for permission to operate in Beijing. Vinson & Elkins is scouting another Asian location. And Haynes and Boone has set its sights on London, Tokyo and China.

—Richard Alm



Banking on Basel: An Alternative for Capital Requirements

By Kory Killgo and Kenneth J. Robinson

Equity capital represents a bank's net worth—the difference between its assets and liabilities. Put another way, it's the value of assets financed by the bank's owners, rather than depositors or other sources of funds. Capital serves as a buffer to absorb losses and prevent failures and figures prominently in the banking industry's ability to lend.

Banks must have sufficient capital to back the risk of lending to consumers and businesses. If banks don't have enough, an economic downturn could force lending cutbacks, further exacerbating the slump. But capital isn't free. It costs money to raise and hold. If banks maintain too much capital, lending becomes more expensive, and banks will do less of it. This, too, could dampen economic activity.

Capital adequacy is a primary concern of regulators. The amount of capital they require banks to hold is based mostly on the size and riskiness of the institutions' assets and their off-balance-sheet exposures. Because banks with riskier portfolios are more likely to incur losses, they need to maintain a bigger capital cushion than safer banks. This principle has been in place since 1988, but the regulations implementing it are likely to change under proposals now being considered.

How might the new regulations impact banks in the Eleventh Federal Reserve District? The answer depends largely on banks' risk profiles. The results, however, could have important implications. The District's many smaller, locally based banks are key sources of financing for small businesses. It could be difficult for these borrowers to establish the same relationships with larger, nonlocal institutions. Since capital supports lending activity, changes to banks' capital profiles could affect credit availability and local economies.

Regulating Bank Capital

Today's capital requirements date to the Basel Capital Accord of 1988, known as Basel I. The accord was hammered out by

the Basel Committee on Banking Supervision to foster regulatory consistency for banks operating across national borders.¹ The committee drew up broad standards and guidelines but left it to individual countries to implement them in ways that suited their own systems. The United States also adopted the standards for smaller, domestic banks.

Basel I groups assets according to perceived credit risk, with each group having a different capital requirement.² Cash in a bank's vault, for example, is virtually risk-free, so it gets a capital requirement of zero, while banks must hold capital equal to 8 percent of their business loans (*Table 1*).

Basel I strengthened the international banking system, but problems emerged. Most important, Basel I asset categories are very broad. All business loans, for example, have the 8 percent capital requirement, regardless of how risky the borrower might be. Under Basel I, capital's role in enhancing banking safety and soundness could be diminished because taking on greater risk doesn't necessarily mean higher capital requirements.

An array of sophisticated banking products—such as swaps, collateralized debt obligations and other off-balance-sheet items—were either not around or in their infancy when Basel I was adopted. And banks' risk measurement and management techniques have improved markedly. Today, most large banks employ sophisticated statistical models to assess risk and the appropriate amount of capital to allocate across exposures.

Recognizing these developments, the Basel committee decided on a new capital framework and in June 2004 endorsed what is known as Basel II. The definition of capital remains the same. What changes is the calculation of capital requirements for individual asset exposures. Banks, with the approval of regulators, will be able to allocate capital based on their own risk assessments.

U.S. regulatory agencies have decided

Capital serves as a buffer to absorb losses and prevent failures and figures prominently in the banking industry's ability to lend.

Table 1
A Sampling of Basel I Capital Requirements

Assets	Capital requirement (percentage of assets in category)
Cash, U.S. Treasury and agency securities	0
Interbank claims, state and local government general obligation bonds	1.6
Residential first-lien 1–4 family mortgages, certain privately issued mortgage-backed securities, state and local government revenue bonds	4
Business and consumer loans, industrial development revenue bonds	8
Certain asset securitizations with long-term, below-investment-grade credit ratings	16

NOTE: The Basel Capital Accord has been revised more than 25 times since its inception, and the asset categories are very detailed. For more information, see *Banking Regulation: Its Purposes, Implementation, and Effects*, by Kenneth Spong, Federal Reserve Bank of Kansas City, 2000.

Table 2
A Profile of Conservative and Aggressive Banks

	Assumed capital requirement (percent)	Loan concentrations (percent)	
		Conservative banks	Aggressive banks
Commercial real estate loans			
Least risky	8	75	20
↓	12	25	20
	16	0	30
Most risky	28	0	30
Consumer loans			
Least risky	4	50	5
↓	6	25	15
	8	25	50
Most risky	12	0	30
Residential mortgages			
Least risky	1.6	30	0
↓	(<= 60% loan-to-value ratio)		
	2.8	60	20
↓	(61%–80% loan-to-value ratio)		
	4	10	50
↓	(81%–90% loan-to-value ratio)		
	8	0	30
Most risky	(91%–100% loan-to-value ratio)		

NOTE: For a complete description of the loan concentrations, see www.csbs.org/Content/NavigationMenu/Home/Basel1aInfo.htm.

that only large, internationally active banking organizations—those with assets of at least \$250 billion or foreign exposure of at least \$10 billion—will be required to adopt the Basel II framework. Others may do so with regulators' approval.³

What about smaller banks? Adhering to Basel II will be costly and complex. While more meaningful risk measures could lead to lower capital requirements, smaller banks probably wouldn't be able to afford the necessary modeling techniques. As a result, two banks with similar risk profiles could face different capital requirements, depending on whether they stuck with Basel I or adopted Basel II.

Responding to these concerns, in October 2005 federal banking agencies released an advance notice of proposed rules for revising Basel I implementation in the U.S. This new approach is known as Basel IA.

As with Basel II, the definition of capital wouldn't change, nor would minimum capital requirements. One important modification being considered is an increase in the number of risk categories. Other proposals include expanding the use of external credit ratings and using loan-to-value

ratios in determining capital requirements for residential mortgages.⁴

Bank Capital in the Southwest

New capital requirements could have important implications for the Southwest. None of the institutions that will be required to adopt Basel II are based in the Eleventh District, but branches of big, internationally active banks hold slightly more than 40 percent of all District bank and thrift deposits.

All District-based banks will likely have to deal with Basel IA. Although the regulations are still being discussed, we can estimate some of their potential impact on bank capital in the Eleventh District. The Conference of State Bank Supervisors (CSBS) has developed an analytic tool that uses data from banks' Consolidated Reports of Condition and Income. This can be used to calculate the change from the minimum capital levels currently required to what Basel IA might mandate.

Banks don't have to report all the information needed to calculate capital charges under Basel IA, so we had to make some assumptions: the percentage of commercial real estate loans in various risk categories, the amount of residential real estate loans in the different loan-to-value ratios and the exposure to borrowers in each rating category. We estimated banks' minimum capital requirements for two risk profiles—one "conservative" and the other "aggressive" (Table 2).⁵

These labels distinguish two hypothetical banks that in the judgment of CSBS staff would occupy opposite ends of the risk spectrum. A conservative bank, for example, has no loans in the riskiest commercial real estate category, while an aggressive bank is assumed to have 30 percent of its loans in this category.

What Basel IA means for the Eleventh District largely depends on the extent to which banks are conservative or aggressive. If we assume all banks fall into the conservative category, virtually all would experience a reduction from

current levels of required capital. We rank the banks from the smallest to the largest percentage reduction in the required minimum. Banks at the fifth percentile would see about a 5 percent decrease in minimum required capital, while those at the 95th percentile would see their requirement drop by slightly more than 20 percent (Chart 1A).

If we assume all banks fall in the aggressive category, their required minimum capital would increase. The increase for banks at the fifth percentile would be almost 5 percent; for those at the 95th percentile, it would be 40 percent (Chart 1B).

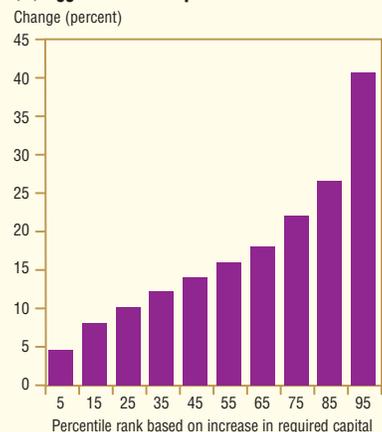
Chart 1
Eleventh District Capital Needs Under Basel IA

Distribution of change in required minimum capital

(A) Conservative Assumptions



(B) Aggressive Assumptions



SOURCE: Consolidated Reports of Condition and Income, Dec. 31, 2005.

While the conservative and aggressive models yield starkly different results, the impact on individual banks could vary considerably, depending on their asset structures.

To get some idea of how Basel IA might affect banks of different sizes, we divided Eleventh District institutions into five groups, based on assets: under \$50 million, \$50 million–\$100 million, \$100 million–\$500 million, \$500 million–\$1 billion, and over \$1 billion.

Under the conservative scenario, smaller banks would see slightly larger decreases in required capital than larger institutions (*Chart 2*). The median decline would be 14 percent for banks with under \$50 million in assets and 8 percent for those with more than \$1 billion in assets. If Eleventh District banks were aggressive, required capital would rise across all asset sizes, with larger banks seeing substantially greater increases than smaller institutions.

Commercial real estate loans could be a factor in these results. Capital requirements in this category range from 8 to 28 percent. Banks with under \$50 million in assets average only 3 percent of their assets in commercial real estate, compared with 12 percent for institutions with more than \$1 billion in assets. When all banks are aggressive, larger banks would see greater increases in required minimum capital because they would have higher

concentrations of commercial real estate than smaller banks.

Would some banks need to adjust their capital positions? To uncover any relationship between banks' holding excess capital and required-capital-level changes under Basel IA, we ranked Eleventh District banks based on the percentage of capital they hold above what's currently required. We then divided this list into 10 groups of equal size and noted the median surplus for each. Banks in the lowest group hold about 33 percent more capital than required, while those at the highest percentile have 360 percent more (*Chart 3*).

As excess capital rises, the median percentage increase in capital under the aggressive approach shows a fairly steady decline. In the conservative scenario, little relationship exists between decreases in required capital and the amount of excess capital banks hold. Based on our preliminary work, it appears that most banks enjoy sufficient capital cushion to absorb potential increases in required capital.

Our work suggests, however, that banks with aggressive portfolios that rank low in excess capital could experience some pressure. Banks in the lowest grouping, for example, would see a median increase in required minimum capital of almost 25 percent, close to their median 33 percent in excess capital. Banks in the next lowest grouping, which now hold excess

capital of 50 percent, could see a median increase of about 20 percent.

Banks can adjust their capital positions in several ways. They can raise more capital, which can be costly in terms of reducing dividends or issuing stock or qualified debt. Another option would be to rebalance their portfolios. Since capital requirements are based on the distribution of assets, banks could reduce the amount of capital they are required to hold by moving toward less risky holdings. This alternative could impact local economies if it means banks scale back their lending.

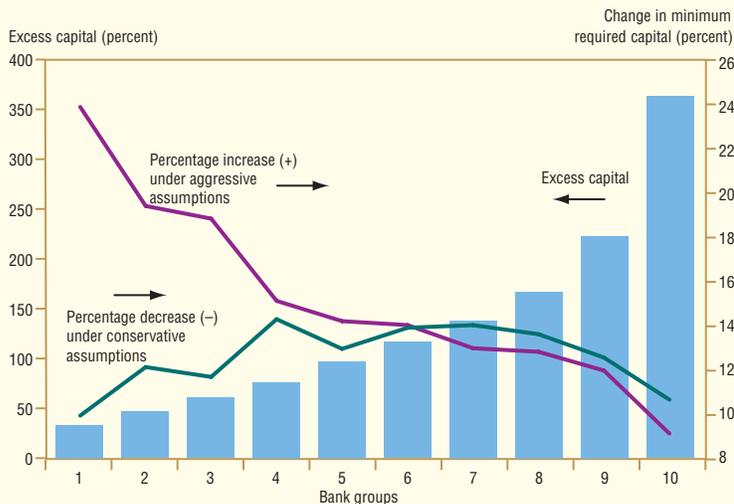
Getting Capital Right

U.S. banking regulators have put much time and effort into reviewing existing capital requirements and proposing revisions. Both larger, internationally active institutions and smaller banking organizations are likely to operate under new capital guidelines in the near future. These revisions will presumably provide more meaningful measures of risk and minimize any competitive inequities.

Our preliminary analysis of the proposed guidelines' impact on Eleventh District banks highlights the risk sensitivity of the changes being proposed under Basel IA. Conservative banks might see declines from current capital requirements, while aggressive institutions might see increases.

(Continued on back page)

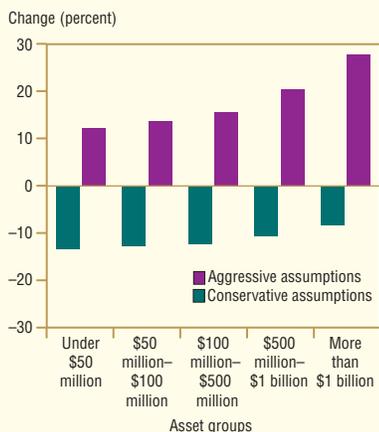
Chart 3
How Would Eleventh District Banks' Capital Requirements Change Under Basel IA?



NOTE: Groups are equal size and based on the percentage by which total capital exceeds the minimum required.
SOURCE: Consolidated Reports of Condition and Income, Dec. 31, 2005.

Chart 2
The Impact of Bank Size

Median change in minimum required capital under Basel IA



SOURCE: Consolidated Reports of Condition and Income, Dec. 31, 2005.

QUOTABLE *“Texas’ ability to grow faster than the nation as a whole has meant we’ve gone from 6.4 percent to 7.4 percent of the U.S. economy in the past 15 years.”*

—Fiona Sigalla, Dallas Fed Economist

TEXAS TRADE: Exports Reflect Dollar’s Ups and Downs

Texas exports more than any other state, so the dollar’s value has a significant impact on overall economic activity.

A decade ago, the Dallas Fed created the Texas Value of the Dollar, an index that tracks the inflation-adjusted exchange rates of the 48 countries most likely to purchase the state’s products.

Each currency enters the index in proportion to Texas’ share of U.S. exports to the country. Mexico’s peso makes up nearly 40 percent, while Canada’s dollar accounts for 10 percent. The remaining 46 countries each contribute less than 5 percent.

Fluctuations in the dollar make Texas exports more

expensive or cheaper in overseas markets. From 2000 through early 2003, the index rose, suggesting foreigners had to pay more for the state’s goods. Texas exports, which grew rapidly in the late 1990s, declined during this period.

The index has been on a downward trend for three years, indicating Texas products have been getting less expensive for foreign customers. With the dollar weaker, state exports have been growing strongly.

The Dallas Fed includes the exchange rate measure in its Texas Leading Index, which forecasts economic activity for the next three to six months. A rise in the dollar’s value affects the leading index negatively. A decline gives it a boost.

ENERGY: High Oil, Natural Gas Prices Filling Texas’ Coffers

Surging energy prices and a strong economy are swelling Texas tax revenues.

Natural gas tax collections went from 1.1 percent of all revenues in 2002 to 2.5 percent in 2005. They were up almost 60 percent in the first four months of this year. At this pace, tax receipts from natural gas production would hit a record \$2.6 billion in 2006 and make up 3.5 percent of projected total revenue.

Oil-related revenues have been rising, too—but not as fast. This year’s estimated receipts of \$861 million would be the highest in 21 years. At that rate, they would account for about 1.1 percent of total state revenue, up marginally from

the 0.7 percent average of the five previous years.

While they’ve increased, the energy industry’s contributions to the state budget remain well below what they were in the early 1980s, another period of high energy prices. Oil’s share of tax collections peaked at 10.1 percent in 1980. Natural gas revenues reached their high point of 7.9 percent in 1982.

Oil prices have been hovering around \$70 a barrel for most of the year. Natural gas, although off its 2005 peaks, still sells for around \$6 per million Btu, well above what it was a few years ago. A drilling boom has brought new wells into production, especially for natural gas.

MAQUILADORAS: Juárez Leads Job Growth at Plants Along Border

Mexico’s maquiladoras usually flourish when U.S. industrial production is rising. So with the American economy humming, it’s not surprising that total employment in the assembly-for-export plants is up 46,539 over the 12 months that ended in May.

Cities along the Texas–Mexico border accounted for nearly eight of 10 new jobs—a total of 35,834. The hot spot has been Ciudad Juárez, opposite El Paso, which posted job gains of 26,498.

Employment increased by 9,991 in Ciudad Reynosa, opposite McAllen, and 1,223 in Matamoros, opposite Brownsville. Nuevo Laredo, Piedras Negras and Ciudad Acuña all lost jobs over the 12 months.

Juárez has been attracting major maquiladora projects. In June, Electrolux opened the biggest industrial building in the state of Chihuahua, a 1.5 million-square-foot refrigerator plant that employs 1,500. That number is expected to grow to 2,500 when the plant is fully operational at year’s end.

The Swedish company has also started construction on a washer and dryer factory that will initially employ 800 workers when it opens in 2008. In addition, Electrolux suppliers have been moving into the city.

Recent data show Juárez’s robust maquiladora growth continuing. It was the only city on the Texas–Mexico border to post significant job gains in May. Outside of Juárez, the region’s maquiladora employment fell by 268 jobs for the month.



Texas Midyear Report Favorable

The Texas economy grew strongly during the first half of the year, with total nonfarm employment posting a 2.3 percent gain. The Texas Coincident Index, an aggregate measure of statewide economic activity, increased 3.2 percent, and private employment gains were robust. Anecdotal evidence from the Eleventh District Beige Book continues to suggest solid economic activity and a tightening labor market. The service sector is still adding jobs at a good clip, but it is the goods-producing sector—manufacturing, construction and energy industries—that is giving the state's economy a major boost.

Several factors are spurring growth in the Texas goods-producing sector. First, oil and gasoline prices remain elevated, dampening consumer spending to some extent but benefiting the state through increased royalty payments and tax revenues. Drilling-related employment and the Texas rig count are on an upswing despite anecdotal reports of labor and equipment shortages.

Second, healthy activity in the construction industry, driven by in-migration and busi-

ness expansion, is propelling the state's economy. Texas construction employment is growing more than twice as fast as its national counterpart (6 percent versus 2.4 percent). Both home demand and homebuilding remain high. Retail construction is solid, and even the office sector, which took a huge hit during the most recent downturn, is witnessing declining vacancy rates and increased construction.

Third, overall manufacturing employment rose slightly in the second quarter (0.4 percent), and average weekly hours worked also ticked up recently. Moreover, the July Beige Book indicates that Texas manufacturing output remains strong, and the Dallas Fed Business Outlook Survey suggests a pickup in production and shipments six months from now.

Jobs are being added in Texas' service-providing sector at a much faster pace than at the national level. Employment growth is fairly broad based, with the key exception being the information sector, which includes Internet service-providing and telecommuni-

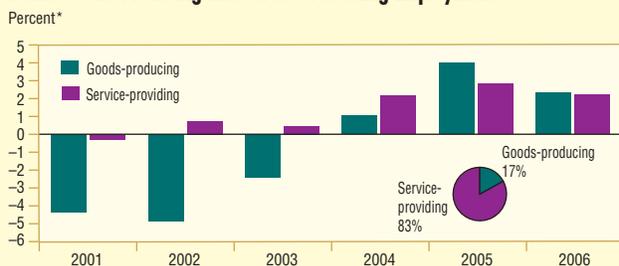
cations firms that are still restructuring. Texas' largest sector—trade, transportation and utilities—added 21,900 jobs at 2.2 percent in the first half of the year, outperforming national job growth in this sector by about 2 percentage points. The professional and business services sector—Texas' second-largest private sector—recorded the strongest growth (5.8 percent), with noteworthy increases in accounting, computer systems design, and architectural and engineering services.

Additionally, the state economy is benefiting from growth in the maquiladora industry along the Texas-Mexico border. Employment in these maquiladoras increased 7.3 percent (13,200 jobs) through May, and most maquiladora industries posted net job gains.

Finally, an increase in the Texas Leading Index during the first half of the year confirms that the Texas economy remains strong and is poised for moderate and broad-based growth in coming months.

—Laila Assanie

Texas Goods-Producing and Service-Providing Employment



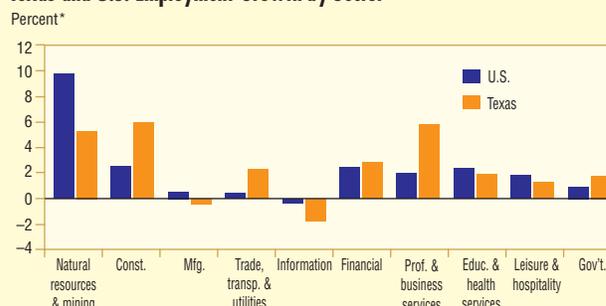
*December-over-December, seasonally adjusted, annualized rate. 2006 figure is June-over-December, annualized.

Texas Construction Contract Values



*Seasonally adjusted, five-month moving average.

Texas and U.S. Employment Growth by Sector



*Year-to-date, seasonally adjusted, annualized rate.

Maquiladora Employment



Banking on Basel: An Alternative for Capital Requirements

(Continued from page 13)

Given capital's key role in banks' financial health, there are important benefits for financial stability and economic activity in refining capital requirements. Imposing unduly high requirements could limit bank lending, with potentially harmful effects on economic activity. Allowing banks to operate with inadequate amounts of capital increases the danger of financial-sector instability and taxpayer exposure to failures. Bank supervisors worldwide have seen the need to update capital requirements in the face of technological change and financial innovation. Basel IA and Basel II are important steps toward getting capital right.

Killgo is a financial industry analyst and Robinson a senior economist and policy advisor in the Financial Industry Studies Department of the Federal Reserve Bank of Dallas.

NOTES

The authors thank Michael Stevens for the use of the Conference of State Bank Supervisors' spreadsheet to calculate changes in capital requirements. They also thank Katherine Wyatt at the New York State Banking Department for assistance and Jeff Gunther for valuable comments.

¹ The Basel Committee on Banking Supervision was established in 1974 by the central bank governors of the Group of

Ten countries. Its members today represent Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the U.K. and the United States.

² Basel I capital requirements are based on risk-weighted, rather than total, assets. The risk weights are equal to the capital requirements multiplied by 1 divided by 0.08. The minimum total capital required is 8 percent of risk-weighted assets. Off-balance-sheet exposures are converted to their equivalent amount of assets and weighted according to perceived risk. In addition to risk-based capital requirements under the Basel accord, U.S. banks must also meet leverage ratio requirements and are subject to prompt corrective actions designed to minimize the cost of failures. These requirements will remain in place.

³ See *International Convergence of Capital Measurements and Capital Standards: A Revised Framework*, at www.bis.org. An updated version published in November 2005 incorporates trading activities and the treatment of double default effects. For the U.S., the notice of proposed rule-making that would implement Basel II can be found at www.federalreserve.gov/generalinfo/basel2/DraftNPR.

⁴ See Federal Register, vol. 70, no. 202, pp. 61068–78.

⁵ Our results can be considered only possible outcomes because they depend on our assumptions, and the advance notice's proposals could be revised before adoption. The data used are from the December 2005 Consolidated Reports of Condition and Income and the Dec. 31, 2005, Uniform Bank Performance Report. Data for small business exposures are from the June 2005 Consolidated Reports of Condition and Income.



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