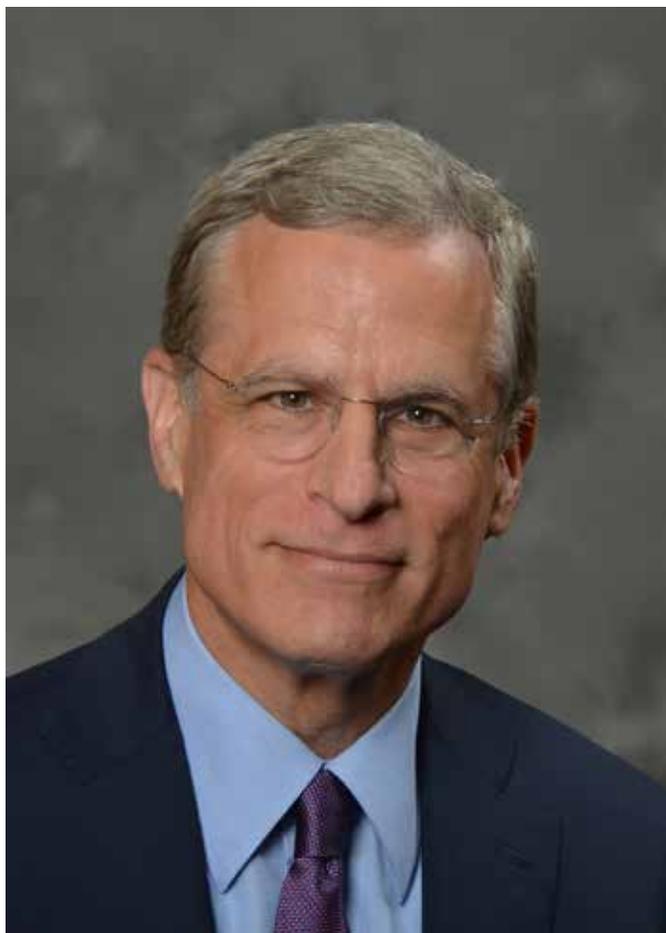


Letter from the President



Due to the underlying strength of the U.S. consumer, U.S. gross domestic product (GDP) growth rebounded in the second half of 2016.

in last year's letter, I wrote about the complexities of being a central banker at this point in our history. Developments over the course of 2016 reinforced that this is, indeed, a complex time.

At the beginning of last year, Federal Open Market Committee (FOMC) participants (including me), on average, expected that we would raise interest rates four times during 2016. However, unexpected financial turmoil in China in the first quarter led to a rapid tightening in financial conditions globally that threatened to materially slow the U.S. economy. First- and second-quarter GDP readings were weak due to the financial turmoil as well as a deceleration in inventory builds by U.S. companies. The surprising June U.K. referendum result on Brexit also had an impact on the Fed's risk-management stance. As a result, FOMC participants revised down their outlook for rate increases, and the Fed ultimately raised rates once in 2016.

Due to the underlying strength of the U.S. consumer, U.S. gross domestic product (GDP) growth rebounded in the second half of 2016. Our economists at the Dallas Fed are currently forecasting in excess of 2 percent GDP growth in 2017. This is sluggish growth by historical standards, but it should be sufficient to allow for further removal of labor market slack and steady progress in achieving the Fed's 2 percent inflation goal.

International Focus

In 2016, I made a number of foreign trips to better understand some of the key issues confronting the global economy. I visited London in April and met with business and government leaders to get a better read on the Brexit debate. In August, I spent a week in China meeting with officials and business leaders to deepen my understanding of the transition that is underway there and the

challenges that Chinese policymakers are facing.

China is the world's second-largest economy and has, in recent years, accounted for about a third of global growth. The country is challenged by high levels of overcapacity in state-owned enterprises, high and rising levels of debt, and a growing issue of capital outflows despite very strong capital controls. As a result, our team at the Dallas Fed continues to closely monitor Chinese conditions. It is our view that the world will have to become accustomed to lower levels of Chinese GDP growth in the years ahead and that China's challenges will create increased vulnerability to financial turmoil, which could, in turn, have an impact on global financial conditions.

We had several visits during the year with senior officials of the Banco de México as well as other senior government officials and business leaders. There has long existed a very strong relationship between the Banco de México and the Federal Reserve Bank of Dallas. The Eleventh District—Texas, northern Louisiana and southern New Mexico—has deep cultural and economic ties with Mexico.

Mexico is Texas' top trading partner. In 2016, Texas exports to Mexico were \$92.7 billion, and it is estimated that these exports supported approximately 1 million jobs in Texas. Dallas Fed economists believe that the trading relationship with Mexico has helped various industries in Texas and the U.S. gain global competitiveness, and this relationship has helped create jobs in the U.S. In addition, Texas border cities have benefited tremendously from the increasing U.S.-Mexico economic integration—leading to job gains, primarily in service sectors, that have resulted in higher wages and improved standards of living for many Texans. The Dallas Fed's Globalization Institute will continue

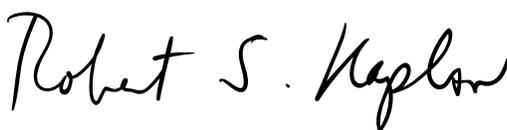
to do research that deepens our understanding of the linkages between the U.S., Texas and Mexico.

The Globalization Institute

The Globalization Institute plays a key role in advancing our understanding of international economies and global economic relationships. The core business product of the institute is its working paper series. These papers are intended for eventual publication in peer-reviewed journals, which is a key metric of research success.

The institute also has an important public outreach mission. Through our Global Perspectives speaker series, the Dallas Fed hosted a Trilateral Conference in February that featured Governor Agustín Carstens of Banco de México and Governor Stephen Poloz of the Bank of Canada. We also hosted former U.S. Treasury secretaries Hank Paulson, Robert Rubin and Larry Summers, Harvard Business School Dean Nitin Nohria and former Bank of England Governor Lord Mervyn King. The Global Perspectives series will be a key part of our outreach initiative at the Dallas Fed in the coming years.

The world's economies and financial markets are more interconnected than ever before. The Federal Reserve Bank of Dallas' Globalization Institute will continue to do comprehensive research that explores these linkages. Our thought leadership and public outreach efforts are intended to provide valuable insight for policymakers and business and community leaders as well as the general public.



Robert S. Kaplan
President and CEO
Federal Reserve Bank of Dallas

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the U.S.**