FEDERAL RESERVE BANK OF DALLAS

Issue 1 January/February 2003

Southwest Economy

Region Lags Nation in Education Gains

The average American became better educated in the 1990s. The number of U.S. adults with at least a bachelor's degree jumped 38 percent between 1990 and 2000, while the number without a high school diploma fell. Entering the 21st century, the average American had more than a year of postsecondary education.

The average education of the adult population increased in every state and the District of Columbia. However, as Chart 1 shows, some states improved much more than others. Intriguingly, gains in average educational attainment were systematically lower in the West and Southwest. In particular, Alaska, California and Nevada posted less than half the national gain. California, which ranked 14th in the nation in terms of average educational attainment in 1990, slipped to 29th by 2000. Texas dropped seven places to 42nd.

Why did the West and Southwest lag the rest of the nation? There are two key factors: The adult population without a diploma did not decline, and the share of the population with at least a bachelor's degree did not rise as rapidly as elsewhere in the country.

(Continued on page 2)

Slow but Steady Progress Toward Financial Deregulation

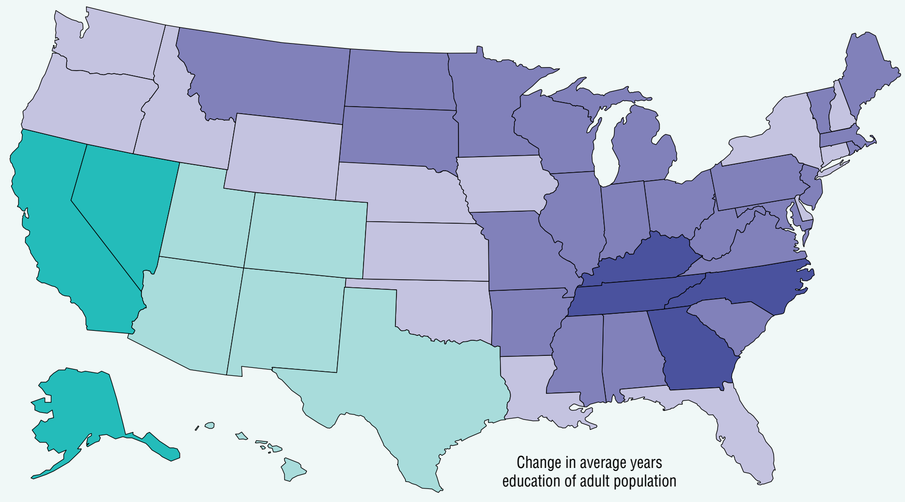
After almost 20 years of trying, in late 1999 Congress finally repealed the Glass–Steagall Act and parts of the Bank Holding Company Act, which had separated traditional banking, insurance and securities underwriting into three, nonoverlapping industries.[1] The Financial Services Modernization Act of 1999, also known as Gramm–Leach–Bliley, was hailed as a major step toward ending government regulation that was initially imposed following the stock market collapse in the late 1920s and the ensuing Great Depression. Proponents claimed that eliminating the artificial barriers that divided the financial sector into distinct industries would increase competition, thus generating greater efficiencies and economies of scale and benefiting consumers and the economy.

(Continued on page 6)

States with the greatest growth in uneducated adults saw the smallest gains in educational attainment.

Chart 1

Gains in Educational Attainment Uneven, 1990–2000



SOURCES: Census Bureau; author's calculations.

Adults Without a Diploma

One reason for the nationwide increase in education was a decline in the number of adults without a high school diploma. According to the census, there were 3.6 million fewer high school dropouts in the United States in 2000 than in 1990, and the share of the adult population without a diploma fell from 25 percent to 20 percent (*Chart 2*).[1]

While the number of high school dropouts fell in most of the country, it rose in eight states—Alaska, New Mexico, Utah, Colorado, Nevada, Arizona, Texas and California (*Table 1*). Not coincidentally, these are also eight of the bottom nine states with respect to gains in average educational attainment during the 1990s. (The other state is Hawaii.) California and Texas, by virtue of their size, experienced the largest absolute increase in population without a high school diploma, while Nevada experienced the largest increase as a share of population.

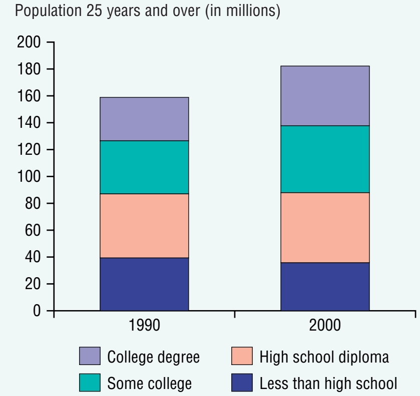
Of course, rapidly growing states attract all types of workers, including those without a high school diploma. The real question is whether the number of educated adults grew faster than the number of uneducated adults. If so, the share of the population without a diploma would have fallen, pushing up average educational attainment. The share of the population without a high school diploma fell in all 50 states, but the decline was smallest in California (where it was almost unchanged), Alaska, Nevada, Arizona, Colorado and Utah.

No matter how you slice it, states with the greatest growth in uneducated adults

Chart 2

U.S. Adults Becoming Better Educated

Population 25 years and over (in millions)



SOURCE: Census Bureau.

Table 1

Number of Adults Without a Diploma Rises in Eight States

	Change in number, 1990–2000	Rate of growth (percent)	Population share, 1990 (percent)	Population share, 2000 (percent)
Alaska	1,038	2.4	13.4	11.7
New Mexico	10,007	4.4	24.9	21.1
Utah	13,696	10.3	14.9	12.3
Colorado	34,983	10.7	15.6	13.1
Nevada	85,746	51.2	21.2	19.3
Arizona	128,467	26.2	21.3	19.0
Texas	242,002	8.4	27.9	24.3
California	492,215	11.1	23.8	23.2
United States	–3,628,093	–9.2	24.8	19.6

SOURCE: Census Bureau.

saw the smallest gains in educational attainment. More than half the variation in average attainment gain can be explained by the growth rate of the population without a high school diploma.

A number of factors could explain why some states saw more rapid growth in this population. States with high dropout rates probably experienced more growth in the dropout population. Unfortunately, there is no measure of dropping out that is consistently defined for all states throughout the 1990s. Statistics for the 38 states reporting in either the 1999 or 2000 school year suggest that higher dropout rates can explain 28 percent of the growth in the population without a diploma. Dropout rates were particularly high in Louisiana (9.2 percent), Arizona (8.4) and Georgia (7.2) and particularly low in North Dakota (2.7), Wisconsin (2.6) and Iowa (2.5). With the exception of Utah (and possibly California and Colorado, for which there are no data), the dropout rate was above the national median for all states where the dropout population grew.

Proximity to Mexico is also a likely explanation for the growth in adults without a diploma. According to the 2000 census, two-thirds of adults living in the United States who were born in Mexico had less than a high school diploma.[2] Therefore, states with a growing population of Mexican immigrants would also tend to have had a growing number of adults without a high school diploma. With the exception of Alaska, the share of the population from Latin America grew rapidly in all the states where the population without a diploma also grew. The share from Latin America more than doubled in Arizona and more than tripled in Colorado and Utah. It increased from 11 percent to 14.5 percent in California and from 6.2 percent to 10.4 percent in Texas. A growing population from Latin America accounts for 41 percent of California's population growth and 29 percent of Texas'; the average for the rest of the nation is 20 percent.

The pattern of population growth in Texas illustrates this point. All major Texas cities posted gains in the number of adults without a high school diploma. Given the state's rapid growth during the 1990s, it would be surprising if they did not. However, as Chart 3 shows, there were sharp differences between cities on the Mexican border and the rest of Texas. While the rest of the state saw large increases in the number of highly educated individuals, much of the border's growth among people age 25 and over was concentrated in individuals without a high school diploma.

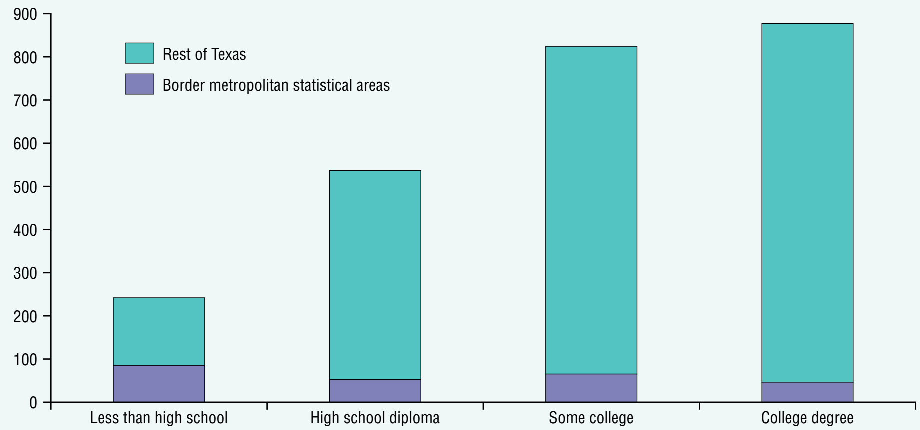
High School Graduates

Of course, a falling share of adults without a diploma means a rising share of adults with a high school or college degree. Therefore, examining the growth in educated adults provides a useful alternative perspective. Nationally, the adult population with at least a high school diploma grew by 22.6 percent between

All major Texas cities posted gains in the number of adults without a high school diploma.

Chart 3

Sharp Differences in Population Growth, 1990–2000



SOURCE: Census Bureau.

The Southwest's mediocre improvement in the share of the population with a diploma isn't due to a lack of growth in educated adults.

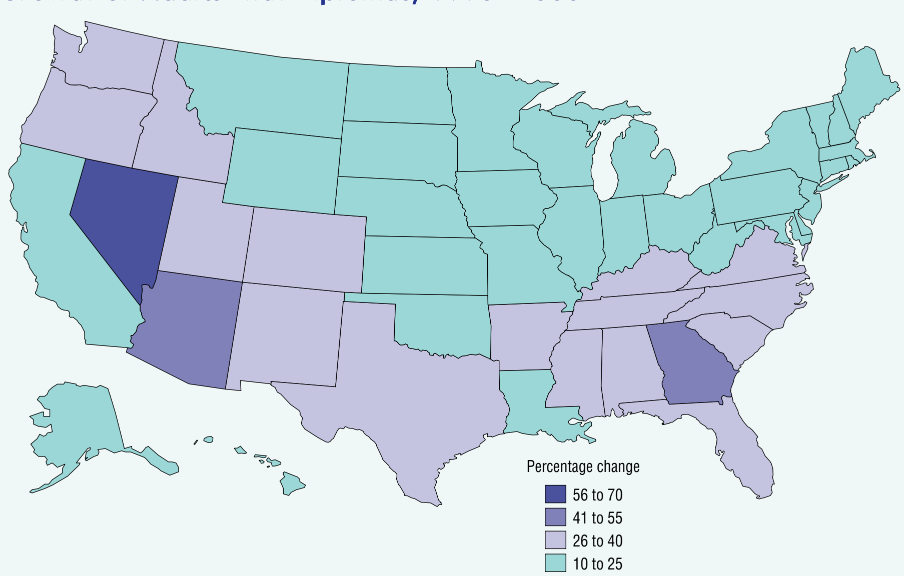
1990 and 2000. However, in Nevada it grew by 70 percent, while at the other extreme, in Connecticut, it grew by only 11 percent.

Chart 4 illustrates the pattern of population growth. The number of adults with at least a high school diploma grew most rapidly in the Southeast, Southwest and West. The notable exception is California, where the adult population with at least a high school diploma grew only 15 percent between 1990 and 2000. The Southwest's mediocre improvement in the share of the population with a diploma isn't due to a lack of growth in educated adults.

The states with the fastest growth in educated adults followed the same basic strategy—they imported them. With the exception of Utah and Idaho, home-grown talent accounts for less than half the growth in educated adults among

Chart 4

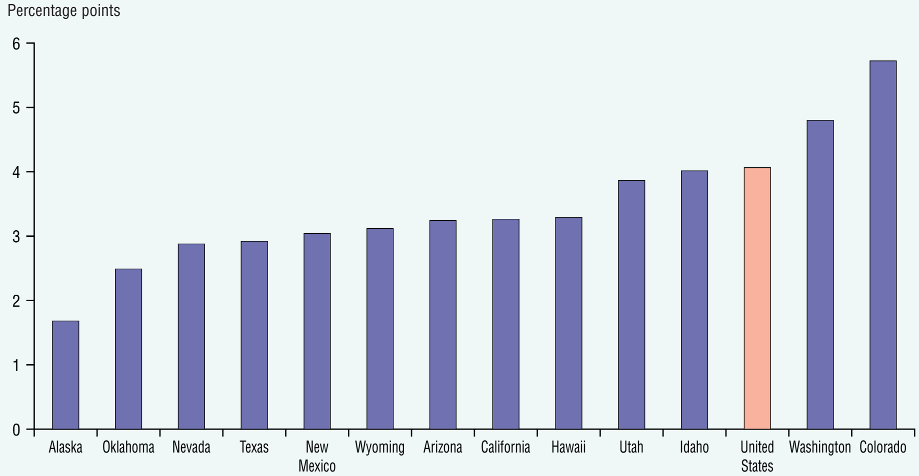
Growth of Adults with Diplomas, 1990–2000



SOURCE: Census Bureau.

Chart 5

Change in Share with a College Degree, 1990–2000



SOURCE: Census Bureau.

the fast-growing states.[3] Nevada, Arizona and Florida graduated no more than one-third of the high school graduates they gained during the 1990s.

In fact, no state other than North Dakota graduated enough high schoolers during the 1990s to account for its gains in educated adults. Nationwide, immigrants who received their high school education abroad account for nearly 40 percent of the net gain in adults with at least a high school diploma.

College Graduates

A more slowly growing share of college graduates is the other major reason the West and Southwest lagged the nation. The share of the U.S. population with at least a bachelor's degree increased by 4 percentage points during the 1990s. As Chart 5 illustrates, the gains were well below average in the Southwest and much of the West. In Texas, the share of the population with a college degree was equal to the national average in 1990 but slipped a full percentage point below it by the end of the decade.

As with high school graduates, most states did not produce enough college graduates to account for the net increase in that population. In the West and Southwest, only Utah was a net exporter of college graduates. Both California and Texas imported nearly one-third of their increase in college-educated adults.

Nationwide, immigrants who received their education abroad account for 20 percent of the net gain in college graduates. Of course, such figures greatly understate the United States' reliance on educated immigrants. Many foreign students come to the United States for college and then return home. Because such students are counted as U.S. graduates, they must each be offset by a foreign-educated immigrant in the net figures. Therefore, it is likely that the share of new, foreign-educated immigrants greatly exceeds 20 percent.

Economic Implications

Lagging the nation with respect to educational attainment gains could have important economic implications for the West and Southwest. Education enhances worker productivity, so firms in the West and Southwest likely experienced less productivity growth than their national counterparts. Highly educated individuals also tend to be highly compensated, so the region's relatively slow growth in average educational attainment likely slowed its growth in personal income per worker.

Relatively slow growth in average educational attainment also deprived states in the West and Southwest of the fiscal advantages conferred by an increasingly well-educated population. Educated individuals' increased earnings lead them to contribute more income, sales, payroll and property taxes. They also tend to demand fewer social services. Educated individuals are less likely to receive welfare, Medicaid or unemployment compensation. They and their children tend to be healthier, which should reduce their use of the public health system.

Conclusions

All states and regions became more highly educated during the 1990s. Much of the growth was homegrown; graduates of U.S. high schools and colleges account for just over 60 percent of the increase in the number of educated adults. However, that left the United States dependent on foreign countries to educate the other 40 percent. The United States was a net importer of education at every level from high school graduate through Ph.D.

The West and Southwest lagged the rest of the country in education gains. Again, migration is an important part of the story. Not only did the region attract large numbers of highly educated individuals, it also attracted large numbers of adults with little or no formal education. This suggests that states in the Southwest and West benefited less from population growth during the 1990s than did other high-growth areas such as Florida, Georgia and North Carolina.

—Lori L. Taylor

Taylor is a senior economist and policy advisor in the Research Department of the Federal Reserve Bank of Dallas.

Notes

1. This category also includes individuals who never attended high school.
2. Half the adults living in the United States who were born in Latin America (which includes Mexico) do not have a diploma. The census does not indicate whether these individuals immigrated as adults or as children who subsequently dropped out of the U.S. school system.
3. In Utah, the number of high school diplomas granted between 1990 and 2000 represents 78 percent of the gain in adults with at least a high school diploma. In Idaho, local graduation figures can explain 61 percent of the growth. In all cases, figures are adjusted to reflect the likely pattern of mortality during the 1990s.

Slow but Steady Progress Toward Financial Deregulation

(Continued from front page)

On the third anniversary of Gramm–Leach–Bliley's passage, the media are focused on the fact that many of its touted benefits have yet to be realized.[2] Large-scale mergers and consolidations in the financial services industry have not occurred, expanded product lines and one-stop financial shopping have not developed, and prices for financial services have not fallen substantially. In addition, banks have been accused of conflicts of interest between their commercial lending and investment banking divisions. This has emboldened consumer advocates and some in Congress to call for reestablishing some of the barriers Gramm–Leach–Bliley eliminated.

This article explores three primary reasons the benefits of Gramm–Leach–Bliley have yet to be fully realized. First, the Glass–Steagall restrictions that separated commercial and investment banking had been slowly eroded over the last 20 years. Thus, Gramm–Leach–Bliley was not as sweeping a piece of legislation as often billed. Second, the recent economic downturn and corporate accounting and governance scandals have inhibited the industry's ability to realize some of the gains from the recent legislation. Third, the writing of regulations fleshing out Gramm–Leach–Bliley has also taken time.

Those who anticipated fast, extensive changes in the financial sector landscape had unrealistic expectations. Despite the slow progress of reform, however, benefits from Gramm–Leach–Bliley have begun to materialize and are likely to increase as the economy improves and banks determine how to best take advantage of their newfound freedom.

Historical Perspective

To understand the impact of Gramm–Leach–Bliley, it's useful to trace the history of Glass–Steagall and examine how the banking industry evolved during the 1990s.

The Banking Act of 1933, often referred to as the Glass–Steagall Act in the popular press, did three important things.[3] First, it established the Federal Deposit Insurance Corp. Second, it gave the Federal Reserve's Federal Open Market Committee the authority to conduct open market operations. (Monetary policy was previously conducted via the discount window.) Third, and most important for this article, the act erected barriers separating commercial and investment banking. (It is only this part of the Banking Act that technically constitutes Glass–Steagall.) Specifically, commercial banks were barred from underwriting or even dealing with corporate, but not government, securities. This division kept banks and investment firms from competing with each other.

Glass–Steagall's passage was largely a result of the public's misconception that commercial banks were chiefly responsible for the stock market crash. This idea gained considerable support after congressional hearings (by the Pecora Committee) documented numerous abuses by banks with regard to their investment dealings—not unlike the current scrutiny of bank lending to corporations such as Enron Corp.[4]

More recently, the 1990s were an extremely good period for the banking sector. Although the decade's strong economic growth is often attributed to technology, the New Economy and government spending restraint, an often overlooked, but crucially important, contributor to that prosperity was a sound and effective banking sector. The decade started with the winding down of the cleanup of the savings and loan crisis, which had begun in the 1980s. As the economy embarked on its historic growth streak, the banking sector also grew and prospered.

Congress passed significant reform legislation in the 1990s. In 1994, the Riegle–Neal Interstate Banking and Branching Efficiency Act repealed the McFadden Act of 1927 and Douglas Amendments of 1970, which had curtailed interstate banking. In particular, the McFadden Act, seeking to level the playing field between national and state banks with respect to branching, had effectively prohibited interstate branch banking.[5] Starting in 1997, banks were allowed to own and operate branches in different states. This immediately triggered a dramatic increase in mergers and acquisitions. The banking system began to consolidate and for the first time form true national banking institutions, such as Bank of America, formed via the merger of BankAmerica and NationsBank.

The decade ended with the passage of Gramm–Leach–Bliley in November 1999. The impact of this legislation was not felt until 2000, as the Federal Reserve Board and the Treasury Department required time to finalize some of the regulations necessary to implement it. Thus, the 1990s were characterized by prosperity and historic deregulation of the banking sector.

Expectations for Financial Deregulation

Proponents of Gramm–Leach–Bliley had argued that a number of benefits would result from deregulating the financial sector and tearing down the artificial barriers erected by Glass–Steagall and the Bank Holding Company Act.

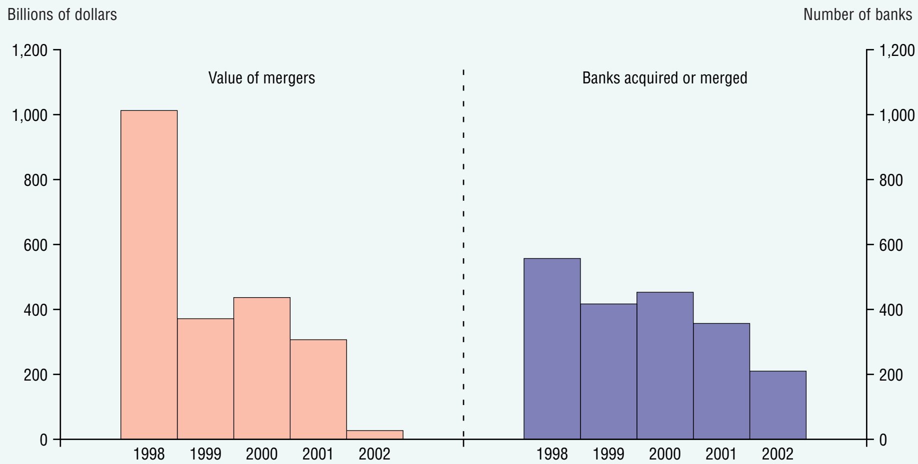
By eliminating the barriers between commercial banking and investment banking, the two sectors would provide greater competition for each other. This would lower prices as banks aggressively competed to underwrite securities and investment banks offered deposit and lending services currently offered by commercial banks.

Proponents also expected considerable consolidation in the financial sector. As banks, investment companies and insurance companies expanded into each other's territory, it was thought that much of this expansion would occur through mergers because companies would find it more cost-efficient to buy existing firms than to start new divisions from scratch. This consolidation would also benefit the economy as these new, large firms achieved economies of scale and passed these efficiency gains on to consumers and businesses. It would also be beneficial to the financial companies because their expanded service offerings would provide greater diversification of assets and risks.

Finally, by allowing banks to offer products such as brokerage services and

Chart 1

Merger Activity Declines



NOTES: 2002 data are for the first three quarters. Dollar value of mergers is for the 50 largest bank holding companies.

SOURCES: Federal Reserve Board; Federal Deposit Insurance Corp.

insurance, new one-stop financial companies would be created. These new financial supermarkets would benefit consumers and businesses by reducing the costs associated with obtaining a variety of services from a diverse group of providers.

Financial Deregulation Reality

Three years after Gramm–Leach–Bliley's passage, many of these expected gains are still largely unrealized. In particular, the mergers and consolidation have not materialized and the creation of one-stop financial centers has been limited. However, as detailed in the next section, it was somewhat unrealistic to expect large gains this quickly.

The lack of consolidation within the financial services industry is evidenced by the general absence of large-scale mergers across industry boundaries. The most notable exception is Citigroup—formed in 1998 from a merger of Citicorp, a bank holding company, and Travelers Group, an insurance company.[6] However, in mid-2002 Citigroup spun off Travelers' property-casualty insurance business.

In general, though, much of the recent merger activity is due to the 1994 repeal of branch banking restrictions and other competitive forces rather than Gramm–Leach–Bliley. Mergers peaked (in dollar terms) in 1998 at $1,013 billion, with only $27 billion in the first three quarters of 2002 (*Chart 1*).[7] The number of mergers displayed a similar pattern. In the mid-1990s, 600 banks per year were acquired as a result of mergers. More recently, that number has dropped to around 350 banks per year.[8]

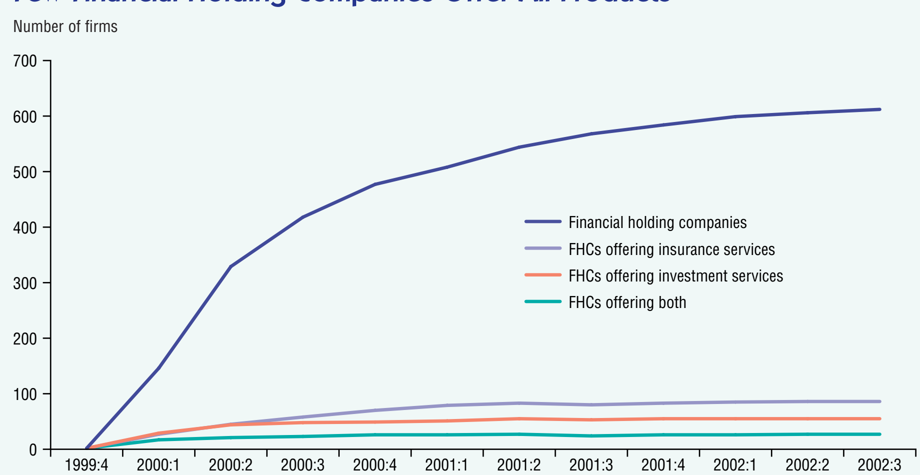
This lack of merger activity between industries has also slowed the creation of one-stop financial centers. Citigroup, by virtue of its merger prior to Gramm–Leach–Bliley, is perhaps the furthest along in terms of having banking, insurance and investment banking under one roof. Other large firms—such as J.P. Morgan Chase & Co., FleetBoston Financial Corp. and State Farm—have succeeded in marrying investment, commercial banking and insurance in a more limited fashion. As of September 2002, 145 investment companies were part of larger financial holding companies. However, only 55 of 612 financial holding companies—a new category of financial services providers explained below—had investment subsidiaries (*Chart 2*). Although these companies represent some of the largest financial companies, the fact that only the largest firms are testing the integration waters—and only to limited degrees—indicates the slowness with which one-stop financial centers are being developed (*Chart 3*).

Why Progress Is Slow

Although the benefits from Gramm–Leach–Bliley seem to be slow in coming, the sluggish pace should not be attributed to a failure of deregulation. There are three key reasons the effects of this legislation have been muted: (1) the barriers between banking, insurance and securities had slowly eroded over time, (2) the recent economic downturn and corporate scandals have hampered banks', insurance companies' and investment banks' ability to take advantage of the recent legislation, and (3) the issuance of regulations has taken time and is, in fact, not yet complete.

Chart 2

Few Financial Holding Companies Offer All Products

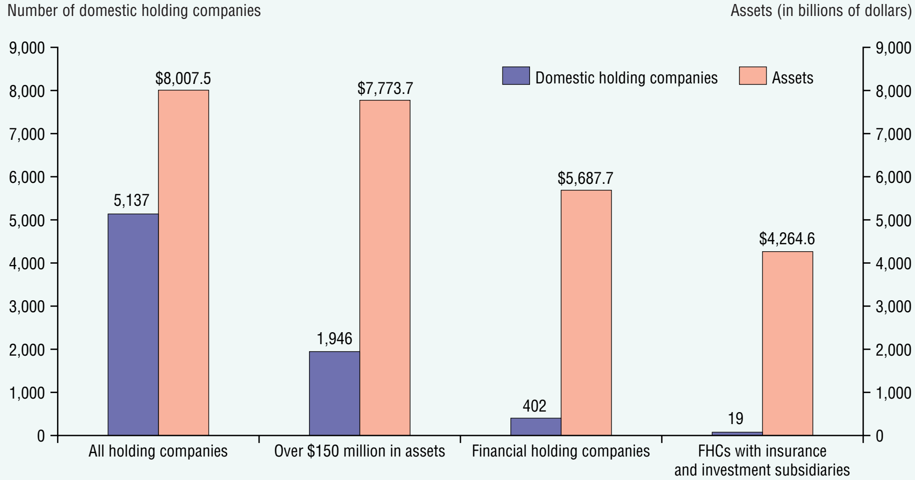


NOTE: A financial holding company (FHC) is the legal structure required for a bank or other institution to engage in brokerage services, insurance services or other financial activity under Gramm–Leach–Bliley.

SOURCE: Federal Reserve Board.

Chart 3

Only the Largest FHCs Testing the Integration Waters



NOTES: Data are for third quarter 2002.

SOURCE: Federal Reserve Board.

Although proponents hailed Gramm–Leach–Bliley for breaking down artificial barriers that had stood for over half a century, the reality is that decisions by the Federal Reserve Board of Governors had slowly chipped away at those barriers over the previous two decades. In 1987 the Board allowed subsidiaries of bank holding companies to do limited securities underwriting. This activity was initially limited to 5 percent of the securities subsidiary's revenues but was increased to 10 percent in 1989 and then 25 percent in 1996. In addition, banks slowly expanded into related areas, such as mutual funds and insurance.

Under Gramm–Leach–Bliley, the first step to offering a diverse portfolio of financial products is receiving the new designation of financial holding company (FHC). In the past, the least restrictive designation for banks was bank holding company.[9] Current bank holding companies or other institutions seeking the new designation must pass basic reviews of financial soundness. As of September 2002, 584 domestic banks and 28 foreign institutions had been designated as financial holding companies. This compares with 5,137 total domestic bank holding companies and 18 partly or wholly owned foreign institutions. Although the number of financial holding companies represents about 12 percent of bank holding companies, it is unlikely to grow dramatically in the near future. Of the 612 financial holding companies, approximately 477 were granted this status during the first year after Gramm–Leach–Bliley's passage and only 135 have obtained this designation in the last two years (*Chart 2*). It should be noted, however, that institutions that have received financial holding company status represent the country's largest banks and financial companies.

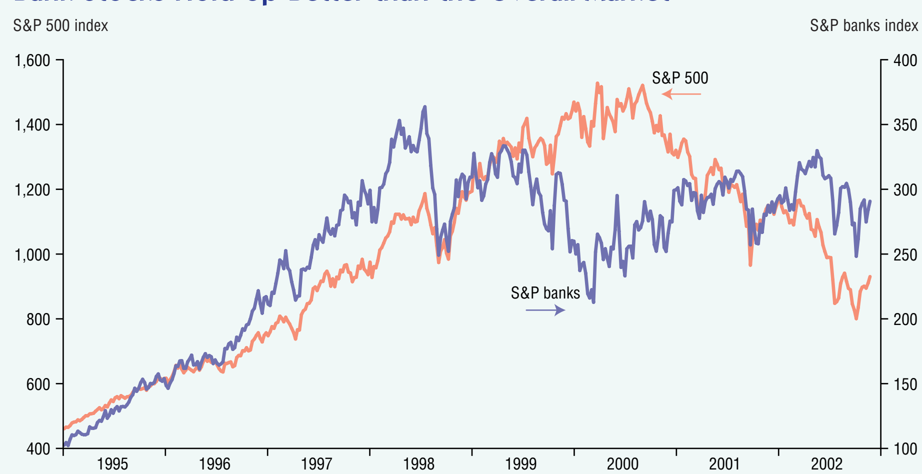
The second reason the full ramifications of Gramm–Leach–Bliley have not been felt is the current spate of corporate scandals and the recent economic downturn, which have reduced mergers and slowed the expansion of products. Overall, however, the banking sector has weathered the slowdown remarkably well.

As with the rest of the economy, the stock market's woes have affected the value of bank stocks, albeit to a lesser degree lately (*Chart 4*). Bank stocks experienced a dramatic run-up in the mid-1990s and then fell significantly between late 1998 and early 2000. It is no coincidence that within the last half decade, stock prices and the dollar value of mergers peaked in the same year, 1998. As with many industries, banks used highly valued stocks to acquire other banks (as opposed to issuing debt to pay cash). Thus, when stock prices came off their highs in 1998, banks were less able to afford mergers and acquisitions.

The economic slowdown has also caused a deterioration in loan quality. The number of delinquencies (missed payments) and charge-offs (uncollectible loans) on loans to commercial and industrial businesses and consumers has risen dramatically since 1998 (*Chart 5*). This loan deterioration has prompted banks to set aside larger reserves to cover expected losses. Given the situation, banks are understandably much more leery of mergers and acquisitions and of expansion into highly volatile areas such as insurance and investment banking.

Chart 4

Bank Stocks Hold Up Better than the Overall Market



SOURCE: Standard & Poor's.

The recent rash of corporate governance scandals has also ensnared the banking industry. Given that Glass–Steagall was a response to alleged abuses by commercial banks with respect to investment banking, it is rather foreboding that only a few years after its repeal, the industry finds itself with similar problems. Large banks have been under attack on several fronts. On the accounting side, Citigroup and J.P. Morgan Chase have been accused of dubious lending deals with Enron. Commercial banks have come under scrutiny for tying loans to investment banking activities and for alleged conflicts of interest between research reports and investment banking opportunities. The latter has resulted in some banks, such as Citigroup (and its investment arm, Salomon Smith Barney), and some investment companies, such as Merrill Lynch, paying large fines. In addition, these companies are considering the degree to which they should make their research departments more autonomous or even independent.

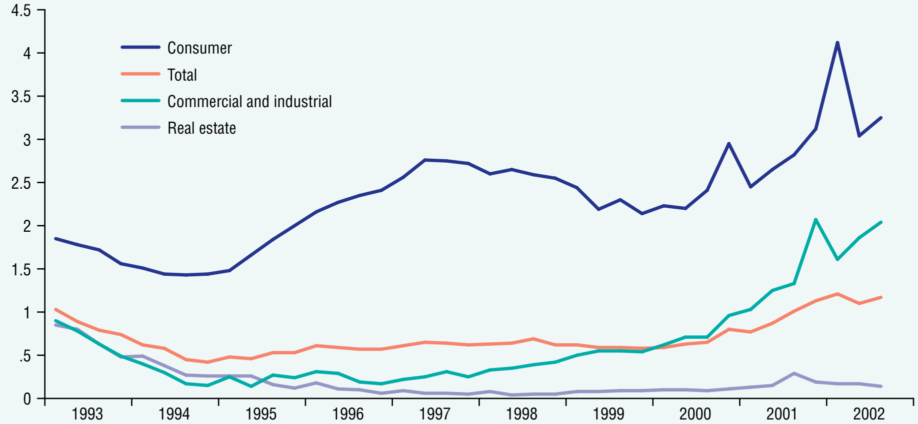
The economic downturn and scandals have led banks to severely curtail or even reverse recent expansion beyond their traditional banking boundaries. As mentioned above, Citigroup has already spun off part of its insurance business. FleetBoston Financial recently closed its investment banking division, Robertson Stephens, because of the nonexistent market for initial public offerings. Bank of America eliminated its auto leasing and subprime mortgage lending divisions because of the weak economy. But although many banks are refocusing on their core business rather than expanding into new territories, once the economy gains momentum, they are likely to test the waters of expansion more aggressively.

The final reason Gramm–Leach–Bliley has taken time to implement is that some provisions are being phased in and others have been delayed while various government agencies create and refine regulations to carry out the law. Since different agencies (for example, the Federal Reserve, the Treasury Department, and the Securities and Exchange Commission) have oversight responsibility for commercial banks, insurance companies and investment banks, the task was further delayed as the agencies coordinated their regulations.

Chart 5

Bank Loans Continue to Deteriorate

Charge-offs as a percent of average loan balance



SOURCE: Federal Reserve Board.

As previously discussed, the first step to offering a diverse portfolio of financial products is being designated a financial holding company. Although satisfying the requirements is not onerous, companies could not apply for this status until the end of the first quarter of 2000, when the applicable regulations were finalized. In addition, several layers of regulations govern the various subsidiaries of financial holding companies. For example, financial holding companies are allowed to engage in merchant banking, which involves directly investing in companies, but the relevant regulations were not finalized until early 2001.[10] And Gramm–Leach–Bliley gives the Federal Reserve and Treasury until 2004 to decide whether banks, in addition to financial holding companies, may engage in merchant banking.

The Treasury still has to decide whether to allow banks to engage in real estate brokerage.[11] Gramm–Leach–Bliley states that banks should be allowed to engage in any activity that is "financial in nature." However, the legislation does not define this term, leaving it to the Federal Reserve Board and the Treasury to jointly determine an appropriate list of activities. So some activities, such as real estate brokerage, must go through the arduous and time-consuming process of first being designated as financial in nature before banks are allowed to engage in them.[12]

Insurance is one of the few markets in which banks have expanded more aggressively. Here again, however, there are regulatory barriers, primarily reflecting the hodgepodge of state-by-state regulations. Thus, although Gramm–Leach–Bliley requires that states permit banks to sell insurance, banks must still adhere to the same regulations as all other insurance companies in each state.

Deregulation Taking Hold

The three years since the passage of Gramm–Leach–Bliley have seen steady but slow progress toward reintegrating the many distinct industries that make up the financial sector. Although some expected immediate, large-scale changes in the commercial banking, insurance and investment banking industries, that has not been the case.

The mergers and consolidation some anticipated have not occurred, and financial supermarkets offering all financial products under one roof have not developed. However, the lack of progress in these areas does not indicate a failure on the part of deregulation. There are many solid economic reasons for the slow pace.

One of the key reasons Gramm–Leach–Bliley did not cause a flurry of activity across traditional banking, insurance and brokerage boundaries is that the barriers separating the three had already begun to fall. Banks did not suddenly

(Continued on page 12)

Chilean Accord Extends U.S. Free Trade Universe by One

After years of fits and starts on a free trade agreement between the United States and Chile—the low point of which was the U.S. Congress' rejection of fast-track authority for the Clinton administration's efforts—the two nations finally reached an accord Dec. 11. The agreement is expected to be signed early this year.

Since implementation of the North American Free Trade Agreement (NAFTA) in 1994, the United States has been slow to enact similar agreements. U.S. recalcitrance at trade liberalization with Chile over the last decade has been particularly striking because Chile's relatively small population of 15 million and status as only the world's 43rd largest economy make it a poor candidate for U.S. protectionism.

All of this masks the more general question of political opposition to freer U.S. trade, inasmuch as the United States does not trade much to begin with, at least as a share of gross domestic product (GDP). Of the 171 nations for which the World Bank collects international trade data, only five (Sudan, Brazil, Argentina, Japan and Myanmar) trade less than the United States as a percentage of GDP.

While the current trade agreement with Chile is a positive event, it temporarily allows continuing U.S. protectionism in some areas. On the plus side for U.S. consumers, more than 85 percent of Chilean exports to the United States will enter duty-free as soon as the treaty goes into effect. By the fourth year, 94.8 percent of Chilean exports overall will be duty-free; however, only about three-fourths of Chilean agricultural exports will enter the United States duty-free by that time.

The distinction between the overall opening of trade and the opening of agricultural trade has been typical of trade agreements not only between the United States and its trading partners but also between other industrial countries and their trading partners. For example, while U.S. trade openings for Chilean consumer and industrial products occur rather rapidly under the agreement, a 3,500-ton quota remains for now on Chilean dairy exports to the United States.

The agreement will also allow tariffs on some Chilean fruits, which are among Chile's most visible products in the United States, to persist 12 years after the agreement takes effect. Similarly, the new accord specifies free trade in wine, but not until 2014. All of this will allow, some say, plenty of time for U.S. protectionists to devise new anticompetitive stratagems. Innovative U.S. protectionists quickly devised political pressures to impede several NAFTA trade openings—including those on Mexican tomatoes and trucking services. A dozen years is ample time to conceive of additional protectionist measures.

On the Chilean side, protectionists also scored some victories against the lower prices immediate free trade would bring. A spokesman for the Chilean Ministry of Agriculture said, "We can categorically affirm that our nation's production of wheat and beets will remain protected...."

Nevertheless, Chile has long been perceived as an attractive place for U.S. citizens to do business. Even though Chile is only the United States' 36th most significant trading partner, just 22 countries receive more U.S. foreign direct investment.

These days the rule of law is operative in Chile. The intellectual property and other legal accords that are part of the new trade agreement will clearly have positive effects on some aspects not only of foreign direct investment but also of portfolio investment, including equities and debt instruments. According to Transparency International's Corruption Perceptions Index, Chile is less corrupt than Germany, Japan or France—to say nothing of a host of other countries.

In any case, it is not a moment too soon for the United States to finally reach such an accord. Both Canada and Mexico—the other two partners in NAFTA—signed free trade agreements with Chile in the 1990s and compete handily against the United States there as a result. Indeed, while total merchandise trade between the United States and Chile between 1995 (the year before the Canada–Chile free trade agreement was signed) and 2001 rose about 2 percent, merchandise trade between Chile and Canada surged 66 percent.

Since the beginning of the last decade, Chile has also signed trade agreements with the European Union, Central America and South Korea. Since NAFTA, the European Union has signed more than 30 trade accords. In contrast, the agreement with Chile is only the second such accord the United States has reached since signing on to NAFTA. But at least it's a start.

—William C. Gruben
Sherry L. Kiser

Gruben is a vice president and Kiser is director of international relations in the Research Department of the Federal Reserve Bank of Dallas.

Regional Update

The Texas economy remains in a mild but prolonged recession, during which its employment has grown at roughly the same rate as the nation's. Absent a sharp drop in oil prices, such a development is unusual for Texas. Since 1992, Texas employment has grown at an annual rate 0.7 percent faster than the nation's. Interestingly, only 0.2 percentage point of that growth was due to Texas having larger shares of fast-growing industries. The other 0.5 percentage point was the result of Texas industries growing faster than their national counterparts.

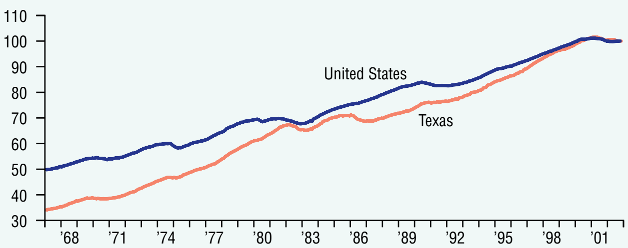
Following sharp losses in 2001, Texas employment contracted slightly in 2002. The manufacturing sector has taken the brunt of the job losses. In October 2002, weekly hours worked in Texas manufacturing fell to 41.7, the lowest level since February 1991. The energy industry continues to contribute little; high energy prices are hurting other sectors but not doing much for oil field activity because the prices are not seen as sustainable. The construction sector continues to cool. The number of homes in inventory has risen to six months, the highest level since 1997. Total Texas mortgage loans past due rose to 6.4 percent in October, roughly the level of early 1991.

The Texas recovery could remain jobless until mid-2003. Texas' typical sources of strength—high tech, exports to Mexico, construction and energy—are unlikely to show much vigor in the early part of the year. In addition, many Texas industries are suffering from overcapacity and structural changes and are not responding to lower interest rates.

—Fiona Sigalla

Texas and U.S. Employment Growing at Similar Pace

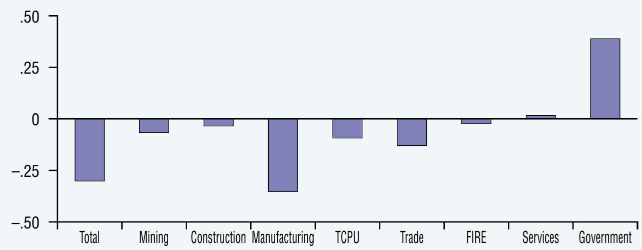
Index, November 2002 = 100*



*Total nonfarm employment.

Sector Contributions to Total Texas Employment, 2002

Percent*

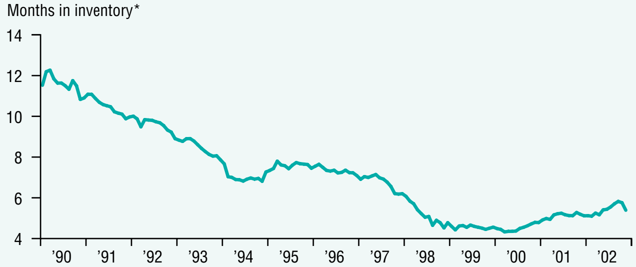


*Year-to-date, seasonally adjusted, annualized rate. Data are through November.

NOTE: TCPU is transportation, communications and public utilities; FIRE is finance, insurance and real estate.

Texas Home Inventory Rises

Months in inventory*

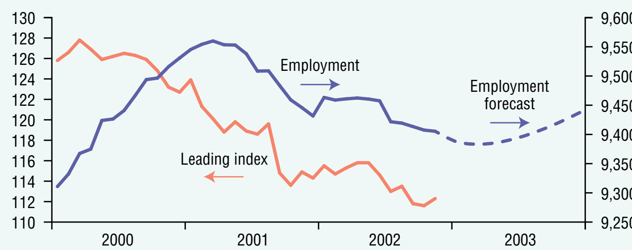


*Seasonally adjusted.

SOURCE: Texas A&M University.

Texas Leading Index and Employment Forecast

Index* Thousands*



*Seasonally adjusted.

Regional Economic Indicators

	Texas Leading Index	TIPI† total	TEXAS EMPLOYMENT* Mining	Construction	Manufacturing	Government	Private service-producing	TOTAL NONFARM EMPLOYMENT* Texas	Louisiana	New Mexico
11/02	112.3	124.0	156.1	556.7	993.9	1,630.8	6,067.9	9,405.4	1,919.4	765.6
10/02	111.6	124.5	156.2	556.3	996.0	1,628.1	6,070.8	9,407.4	1,921.2	764.1
9/02	111.8	125.2	155.8	556.0	998.5	1,626.5	6,076.6	9,413.4	1,920.4	759.5
8/02	113.5	125.1	158.2	556.3	1,001.9	1,621.5	6,081.4	9,419.3	1,922.0	759.6
7/02	113.0	125.3	156.8	558.9	1,005.1	1,618.2	6,082.7	9,421.7	1,912.5	762.8
6/02	114.6	124.9	158.0	559.3	1,006.2	1,621.7	6,112.3	9,457.5	1,916.7	762.5
5/02	115.8	125.0	159.3	559.9	1,009.7	1,614.4	6,117.2	9,460.5	1,919.9	761.0
4/02	115.8	124.5	160.1	559.7	1,012.6	1,610.3	6,119.6	9,462.3	1,921.4	761.1
3/02	115.3	124.1	159.5	560.0	1,014.0	1,609.8	6,117.6	9,460.9	1,923.5	762.5
2/02	114.7	124.4	160.8	559.4	1,018.0	1,606.7	6,113.9	9,458.8	1,922.9	762.9
1/02	115.5	124.5	161.7	561.1	1,024.8	1,603.4	6,112.3	9,463.3	1,926.1	762.2
12/01	114.3	125.4	161.9	559.7	1,024.5	1,597.2	6,088.3	9,431.6	1,925.5	758.3

* In thousands. † Texas Industrial Production Index.

For more information on employment data, see "Reassessing Texas Employment Growth" (*Southwest Economy*, July/August 1993). For TIPI, see "The Texas Industrial Production Index" (Dallas Fed *Economic Review*, November 1989). For the Texas Leading Index and its components, see "The Texas Index of Leading Indicators: A Revision and Further Evaluation" (Dallas Fed *Economic Review*, July 1990). Online economic data and articles are available on the Dallas Fed's Internet web site, www.dallasfed.org.

Slow but Steady Progress

(Continued from page 9)

achieve the ability to sell stocks and bonds; their securities subsidiaries were now allowed to generate more than 25 percent of their revenue from such activities. Consequently, the industry has seen slow expansion across boundaries, as opposed to wholesale changes in products and services.

The recent economic downturn, coupled with accounting and investment scandals, has also dampened banks' ability and desire to create and support new products in which their expertise is limited. Finally, the removal of barriers was not intended to be accomplished over a relatively short period. Congress used general language in much of the legislation to give regulators the flexibility to adapt to ever-changing market forces. However, this flexibility has a price—the time it takes different agencies to develop and agree on regulations.

As regulations and their interpretations are made clear and the economy revives, financial companies that fulfill the promise of Gramm–Leach–Bliley are likely to be formed, furthering competition in the financial sector.

—Mark G. Guzman

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

Notes

I would like to thank Bob Moore, Ken Robinson, Alan Viard and Monica Reeves for their helpful comments and suggestions. The research assistance of Jamie Lee, Dan Lamendola, Kory Killgo and Kelly Klemme are also gratefully acknowledged.

1 The Glass–Steagall Act separated commercial banking from investment banking. Restrictions on insurance sales were the result of the Bank Holding Act of 1956 and subsequent amendments.

2 For example, see "In Focus: Rethinking the Business Case Behind Some of GLB's Changes," *American Banker*, Nov. 8, 2002.

3 See Frederic S. Mishkin, *The Economics of Money, Banking, and Financial Markets*, 5th edition, Addison-Wesley, New York, 1997, for more detailed explanations regarding important banking legislation.

4 It is not clear, in hindsight, that banks did anything wrong. See Randall S. Kwoszner and Raghuram G. Rajan, "Is the Glass–Steagall Act Justified? A Study of the U.S. Experience with Universal Banking Before 1933," *American Economic Review*, September 1994, for a more detailed look at the impact of banks' securities underwriting on the stability of the financial system.

5 Not all interstate branching was eliminated, as various states entered into regional pacts that allowed some interstate branching or holding companies.

6 This merger occurred prior to Gramm–Leach–Bliley and was one of the primary forces in getting the legislation through Congress. If not for Gramm–Leach–Bliley, Citigroup would have been required to divest itself of its insurance underwriting.

7 These dollar figures are for the 50 largest bank holding companies in the United States.

8 Standard & Poor's Industry Surveys: Banking, Nov. 7, 2002.

9 Bank holding companies themselves were largely the result of banks attempting to circumvent the interstate branching restrictions imposed by the McFadden Act.

10 See Kenneth J. Robinson, "Banks Venture into New Territory," Federal Reserve Bank of Dallas *Economic and Financial Policy Review*, vol. 1, no. 2, 2002, for a more detailed exposition of merchant banking and how banks have pursued this new authority since Gramm–Leach–Bliley's passage.

11 See Karen Couch, Robert Mahalik and Robert R. Moore, "Banks as Real Estate Brokers—Letting Free Enterprise Work," Federal Reserve Bank of Dallas *Southwest Economy*, May/June 2001, for a more detailed overview of the banking industry's struggle to obtain permission to engage in real estate brokerage services.

12 Bills were introduced in the newly convened 108th Congress (in both the House and Senate) to prohibit banks from engaging in real estate brokerage.

FEDERAL RESERVE BANK OF DALLAS

Southwest Economy

Southwest Economy is published six times annually by the Federal Reserve Bank of Dallas. The views expressed are those of the authors and should not be attributed to the Federal Reserve Bank of Dallas or the Federal Reserve System.

Southwest Economy is available free of charge by writing the Public Affairs Department, Federal Reserve Bank of Dallas, P.O. Box 655906, Dallas, TX 75265-5906, or by telephoning (214) 922-5254. This publication is available on the Internet at **www.dallasfed.org**.

Federal Reserve Bank of Dallas
P.O. Box 655906
Dallas, TX 75265-5906

ADDRESS SERVICE REQUESTED

PRSRT STD
U.S. POSTAGE
PAID
DALLAS, TEXAS
PERMIT NO. 151