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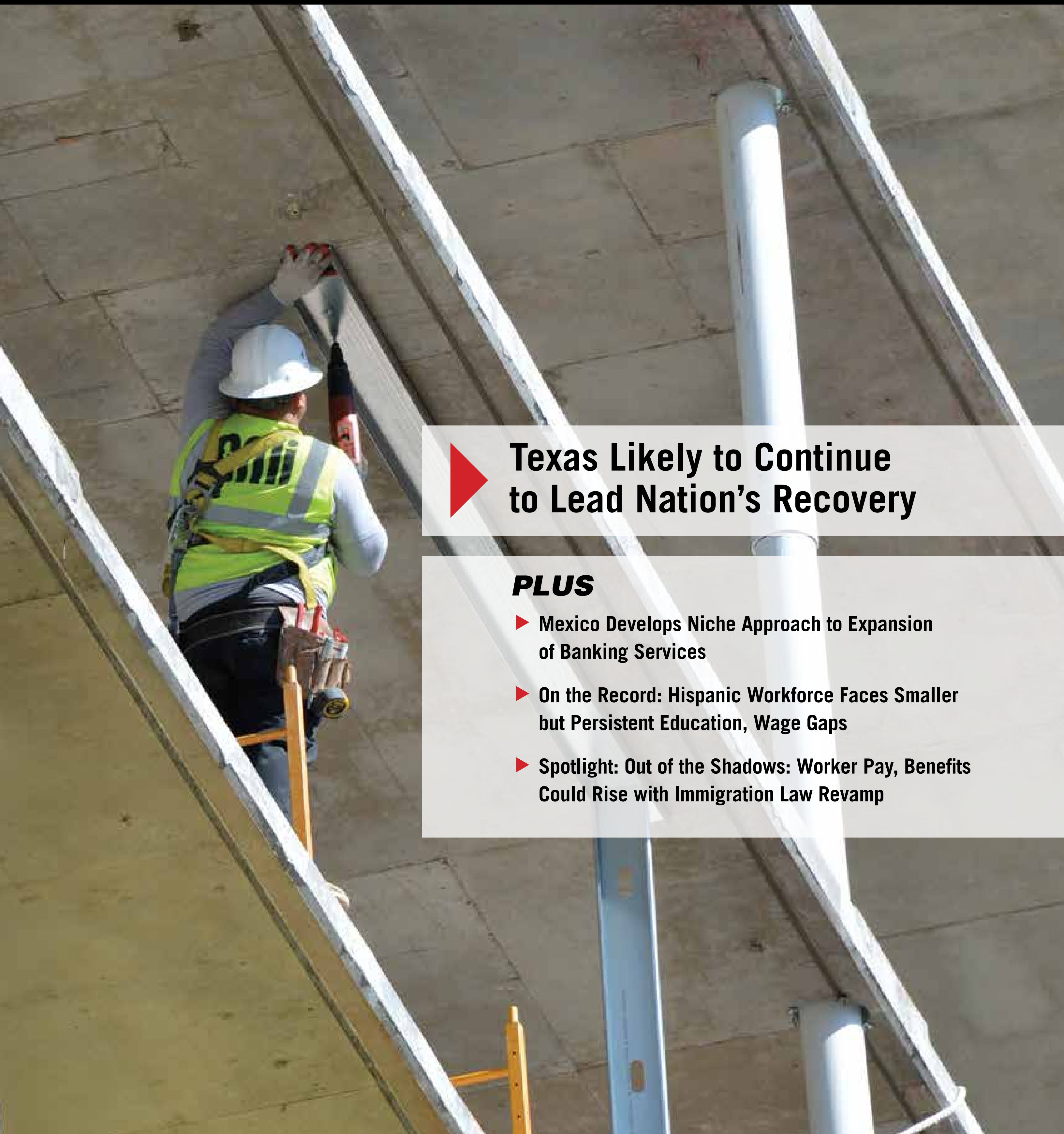
Southwest Economy



Texas Likely to Continue to Lead Nation’s Recovery

PLUS

- Mexico Develops Niche Approach to Expansion of Banking Services
- On the Record: Hispanic Workforce Faces Smaller but Persistent Education, Wage Gaps
- Spotlight: Out of the Shadows: Worker Pay, Benefits Could Rise with Immigration Law Revamp

As 2013 has unfolded, there has been increased attention on revamping our immigration laws. This issue's "Spotlight" article adds to the debate by exploring the economic effects of immigration reform.

The Federal Reserve does not have a role in the planning or execution of federal immigration policy. That is the purview of our elected officials. Yet, immigration policy impacts our economy, so I closely follow the research and the debate. As a first-generation American, it is also of personal interest.

My parents were immigrants. My father's story is especially compelling. At the age of 5, abandoned by his mother, he was found sleeping under bridges and begging for food in Queensland, Australia. He was sent to a reformatory, then to an orphanage, then to a series of brutal foster homes. He "escaped" to South Africa by ship—where he found work driving buses and doing odd jobs—and made enough money to marry my mother and sail for the promised land of the United States, only to discover he couldn't enter because of his record and lack of documentation.

He took up residence in Tijuana, Mexico, and applied for U.S. citizenship. In 1947, he finally got it. With U.S. passport in hand, he went to work securing the well-being of his family: He worked for a U.S. chemicals company in Shanghai and sold tools and silver in Mexico, airplanes in Indonesia, used cars in Florida, men's suits in New York and women's undergarments in the Caribbean—anything and everything he could to make a living and give me opportunities he never had.

The U.S. is the only place in the world where my family's story is not unique, but commonplace. It's important that we keep it that way.

He succeeded. In one generation, we went from homeless to Harvard, from begging for food on the streets to president and chief executive officer of the Federal Reserve Bank of Dallas and a member of the Federal Open Market Committee, the Fed's principal monetary policymaking group.

Ours is a quintessential American story. It has happened time and again, not just to tough, determined, adventurous Australian immigrants like my father, but to Irish immigrants escaping famine, Jews fleeing tyranny, Mexicans, Haitians, Vietnamese, Chinese, Filipinos, Nigerians—people from every corner of the world, seeking a better life.

I am thankful for what American openness to gutsy immigrants has given me. The U.S. is the only place in the world where my family's story is not unique, but commonplace. It's important that we keep it that way.

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

Texas Likely to Continue to Lead Nation's Recovery

By Keith R. Phillips

The prospects for Texas' economic expansion in 2013 appear slightly less robust than its performance in 2012, when the state exceeded its long-term trend and was stronger than most other states.

Illustrating the growth, employment increased 3.1 percent in Texas in 2012. State and local government jobs, recovering from steep cuts in 2011, paced labor market improvement as the Texas unemployment rate declined sharply to 6.1 percent from 7.4 percent in December 2011.

Private sector job growth stood at 3.7 percent last year as slowing manufacturing and energy growth was offset by acceleration elsewhere, particularly in construction. Weakening export demand damped manufacturing. Energy expansion was relatively brisk but not as vigorous as in 2011, reflecting reduced natural gas drilling, as gas prices remained near historical lows.

Only North Dakota and Utah exceeded Texas in job growth last year (*Chart 1*). A recent study of U.S. oil and gas production found that the six fastest-growing states from 2006 to 2011 were the ones with the highest share of energy employment—Wyoming, Texas, Oklahoma, North Dakota, Alaska and Louisiana.[1] With oil prices generally stable at high levels but natural gas prices low, energy was important to state growth last year. Several states hit hard by the housing bust—most notably, Arizona, Nevada, Florida and California—bounced back last year to post job growth exceeding the national average.

In 2013, Texas is likely to see faster economic growth than most U.S. states, although the pace will slow somewhat as manufacturing reflects weak international demand and energy extraction continues its moderation. Ongoing acceleration in construction, however, will likely offset much of this weakness, with likely overall job growth for the year of 2 to 3 percent.

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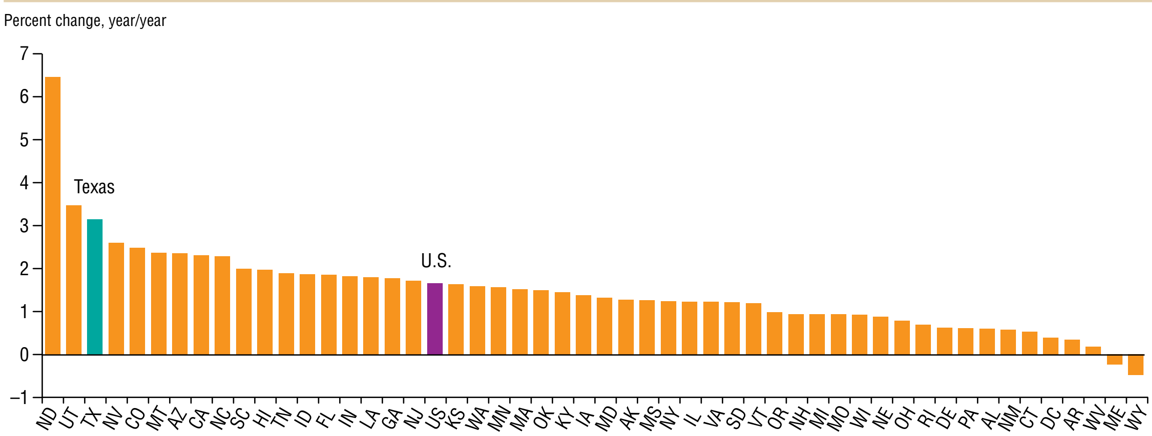
Government Jobs Uptick

Texas state government jobs began to rebound in 2012 even as Washington's budget woes became higher profile. While the federal "fiscal cliff" captured attention at year-end, many other states had already slipped off the edge. Most

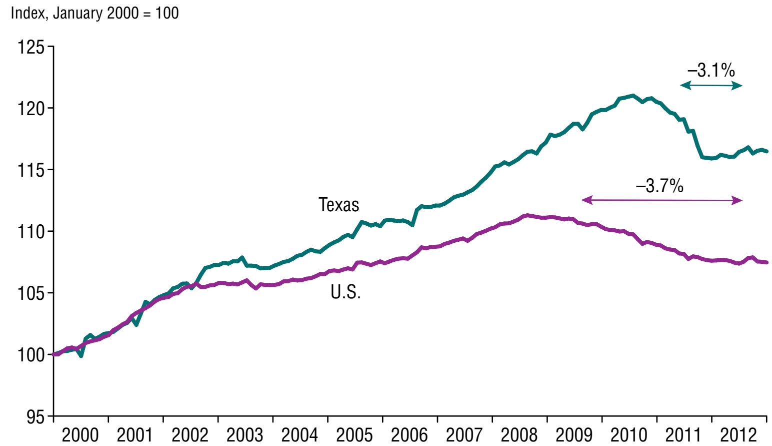
Chart 1 Texas Job Growth Third-Fastest in Nation in 2012



SOURCE: Bureau of Labor Statistics.

After declining 3.6 percent in 2011, state and local government jobs in Texas increased 0.8 percent last year—a swing of more than 4 percentage points.

Chart 2 Texas State and Local Government Jobs Increase in 2012



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

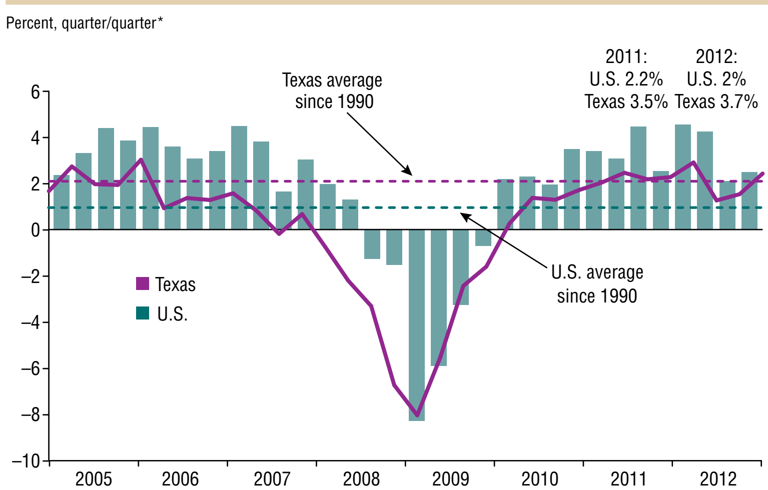
are constitutionally required to balance their budgets, and the steep recession in 2008 and 2009 prompted sharp spending and jobs cuts.[2]

Nationally, state and local government revenues about equal those of the federal government. However, in terms of jobs, state and local jurisdictions account for about 82 percent of public sector employment. State and local government jobs peaked in early 2008, subsequently declining 3.7 percent (*Chart 2*).

In Texas, the sector reached a high in early 2010 and fell a cumulative 3.1 percent through 2012. After declining 3.6 percent in 2011, state and local government jobs increased 0.8 percent last year—a swing of more than 4 percentage points.

Nonfarm job growth overall held steady in Texas in 2011 despite a sharp pickup in the private sector, but improving state and local government hiring and a steadily expanding private sector paced the state's increased activity in 2012 (*Chart 3*).

Chart 3 Texas Private Sector Job Growth Strong in 2012



*Seasonally adjusted annual rate.

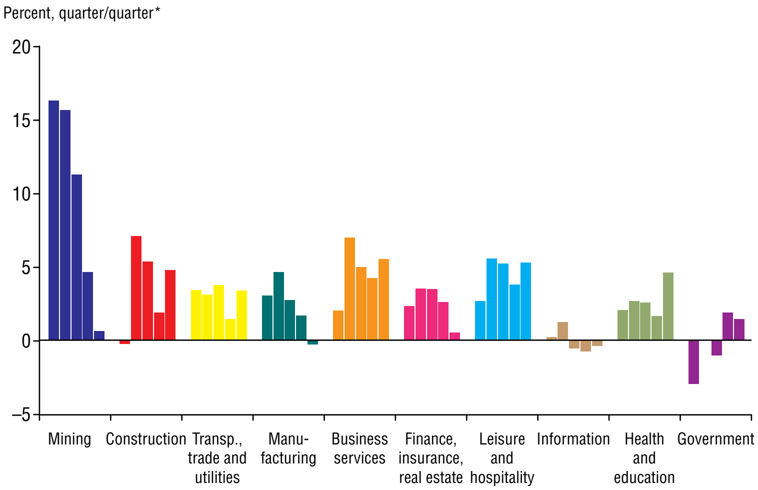
SOURCES: Bureau of Labor Statistics; Federal Reserve Bank of Dallas.

Energy and Manufacturing Slowing

Energy and manufacturing grew briskly at the beginning of 2012, but as the year progressed, both slowed (*Chart 4*). Mining was particularly strong in the first half, with employment expanding at a more than 10 percent annual pace. As natural gas drilling declined, mining employment decelerated in the second half. The state rig count peaked at 938 in mid-June and dropped 12.4 percent to 822 rigs by the end of December.

Manufacturing, on the strength of exports, also started the year strongly. Petrochemical exports remained particularly robust due to low-priced natural gas, which is used as an input in production and as a source of power.[3] Slowing international economic expansion suppressed export growth as 2012 progressed. The real (inflation

Chart 4 Mining, Manufacturing Job Growth Weakening; Construction, Government Improving in Texas



*Seasonally adjusted annual rate for five quarters (fourth quarter 2011 to fourth quarter 2012).
SOURCES: Bureau of Labor Statistics; Federal Reserve Bank of Dallas.

adjusted) value of international exports from Texas, which advanced at a 7.4 percent annual rate in first quarter 2012, averaged only about 1 percent annualized growth in the remaining three quarters.

Construction Shows Strong Gains

Construction emerged as an area of strength, reflecting low mortgage rates and tight inventories. Job growth increased from 1.2 percent in 2011 to 4.0 percent in 2012, though the pace slowed in the second half of last year, as seen in Chart 4. Construction activity picked up in the industry's three major sectors.

In residential building, multifamily grew rapidly earlier in the year and single family accelerated in the second half.[4] With both key areas gaining strongly, the five-month moving average of real residential contracts in December 2012 was the highest since August 2007.

Nonresidential, which includes office, industrial and commercial buildings, began climbing near midyear (*Chart 5*). Much of this improvement reflects gradually declining office vacancy rates in major Texas metropolitan areas—from 18.3 percent in second quarter 2010 to 16.1 percent in third quarter 2012.

In the nonbuilding sector (generally infrastructure), a sharp rise was due to the start of several major projects, including a large wind farm, two gas-fired power plants and a university stadium.

A Less-Robust 2013

While Texas economic growth has exceeded the national average in recent years, the state doesn't perform independently of U.S. or global activity.

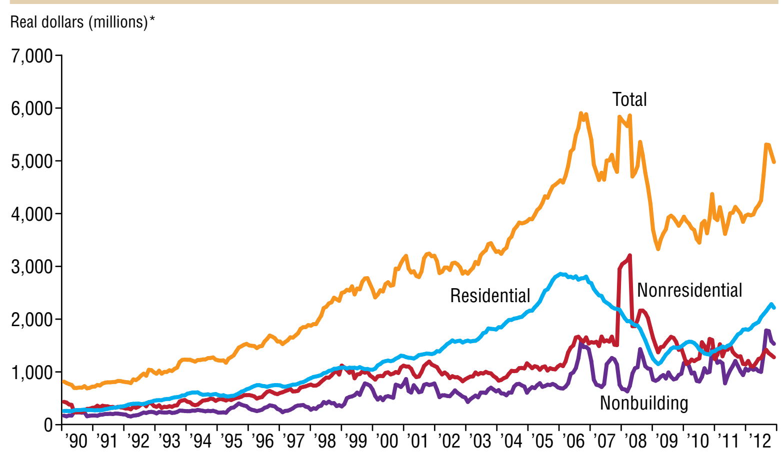
The Organization for Economic Co-operation and Development anticipates world real output growth will pick up from 2.9 percent in 2012 to 3.9 percent in 2013, with the euro area improving from a 0.5 percent contraction last year to a 0.6 percent expansion in 2013. In Mexico, Texas' largest export destination, Banco de México predicted that real gross domestic product (GDP) growth should slow this year to 3.6 percent from 3.9 percent in 2012.

Meanwhile, the Blue Chip economic forecast, an average of about 50 U.S. estimates, showed in March that U.S. real GDP would expand 2.3 percent from fourth quarter 2012 to fourth quarter 2013, following a 1.6 percent rise in 2012.

Thus, while U.S. and world economic activity is expected to pick up somewhat, overall growth is likely to remain modest. That suggests Texas manufacturing may be weak in 2013.

However, construction-related manufacturing, which represents about 12 percent of manufacturing jobs in the state, rose at a 3.6 percent annual rate in fourth quarter 2012 and is likely to improve this year. The three top export-related industries, representing 15.4 percent of manufacturing jobs, declined in the final quarter of 2012—electrical equipment at an annual rate of –5.4 percent, transportation equipment at–4.9 percent and primary metals at –8.8 percent.

Chart 5 Texas Construction Contract Values Trending Higher



*Five-month moving average, seasonally adjusted.
SOURCES: F.W. Dodge; Federal Reserve Bank of Dallas.

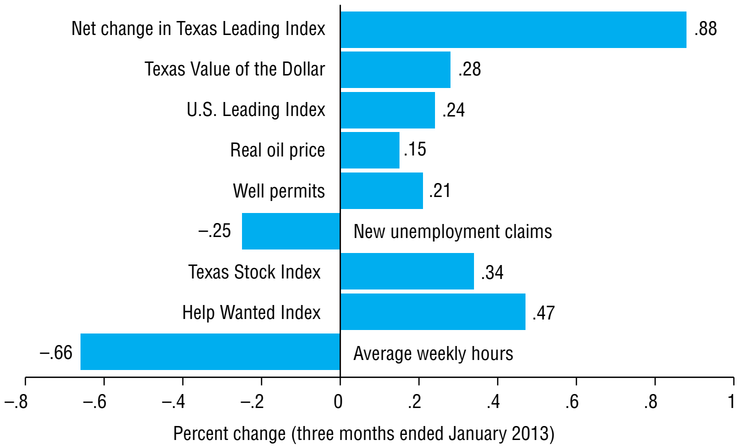
Texas' energy sector will likely soften in 2013. The Energy Information Agency predicted in December that North Sea Brent crude prices would average about $103 per barrel—a modest decline from the $108 to $111 prices near year-end 2012. Futures markets suggest that the price of West Texas Intermediate crude may be flat to slightly higher this year. West Texas Intermediate has been selling for about $20 less per barrel than Brent because of booming oil production in Canada, North Dakota and parts of Texas that flooded the Midwest and midcontinent markets and led to distribution bottlenecks.[5]

A capacity expansion in January in the Seaway pipeline, which carries crude oil from the nation's major distribution hub at Cushing, Okla., to refining and petrochemical complexes around Texas City on the Gulf Coast, reduced the spread to about $19. As new pipelines and other forms of energy transport move more oil from this region, the price spread will likely continue narrowing. A reduced spread would likely mean higher prices for Texas producers, particularly in areas such as West Texas, far removed from Gulf ports.

Natural gas prices inched higher from historical lows last year. Drilling in regions of dry gas in Texas (versus areas with natural gas hydrocarbons that turn to liquid as the gas exits a well) declined sharply in response to prices—a trend likely to continue in 2013. Permits to drill oil and gas wells in Texas declined 17 percent in the second half of 2012, indicating weaker energy extraction growth at least through the first half of 2013.

State and local government employment growth will likely be stable this year. The Texas comptroller's office in January estimated that the state will end its current two-year budget cycle with $8.8 billion in unanticipated funds, and revenue available for the 2014–15 biennium will increase 12.4 percent. Energy extraction is responsible for much of the state's budgetary improvement. Although some of the available funds will likely pay bills that were deferred, the budget has enough cushion for state and local jobs to increase at about the same restrained pace as in 2012.

Chart 6 Changes in Texas Leading Index Components Mixed



SOURCES: Federal Reserve Bank of Dallas; Conference Board; Haver Analytics; Texas Workforce Commission.

Construction offers mixed prospects following a healthy second half of 2012. While nonbuilding activity is unlikely to continue at the recent pace, residential construction indicators suggest that growth is likely to stay strong in 2013.

The inventory of unsold homes relative to sales was 4.6 months in January—the lowest level since September 2000. Inventories below about 6.5 months of supply are historically consistent with rising home prices. Existing-home sales and single-family residential building permits shot up, with sales rising at an annual pace of 7.6 percent in the fourth quarter and permits rising at a 9.5 percent annual rate.

Office construction is also likely to increase this year in response to a decline in the vacancy rate to 16.1 percent—a vacancy rate of 16 percent or lower has previously prompted new building.

Texas Leading Index

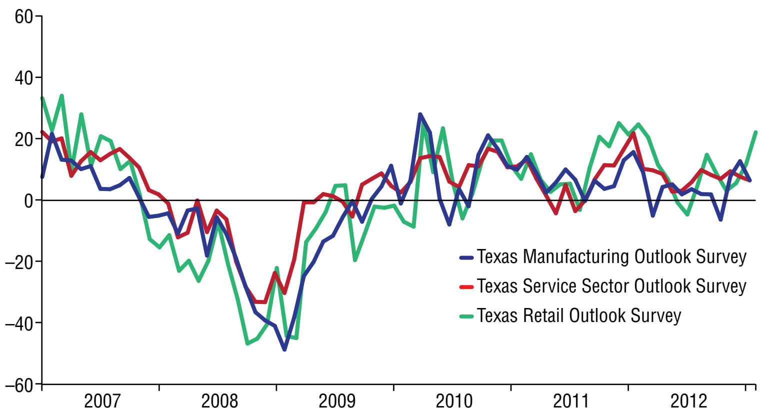
The Texas Leading Index combines movements in key state economic indicators and is used to forecast job growth. In the three months ended in January, the index's components have been broad-based, with six of the eight components contributing postively to growth. Positive contributions came from the Texas Value of the Dollar (meaning Texas-produced goods and services were more affordable abroad), the U.S. Leading Index, the real oil price, oil and gas well permits, the share prices of publicly held Texas-based companies and help-wanted advertising (*Chart 6*).

Negative contributions came from initial claims for unemployment insurance (claims rose) and average weekly hours worked in manufacturing. In general, most indicators continue to suggest positive growth in the state's economy, although some increases in claims for unemployment insurance and a decline of hours worked in manufacturing suggest some caution.

Recent movements in the Texas Leading Index are consistent with changes in Texas company outlooks as measured by the Texas manufacturing, service and retail sector outlook surveys from the Federal Reserve Bank of Dallas. The company outlook index for the three sectors reflects the difference between the percent of firms reporting an improved outlook and those saying it has worsened.

While manufacturing and retail showed some improvement in recent months, all three indexes softened in

Chart 7 Company Outlooks Soften in Second Half of 2012



NOTES: A reading of zero means an equal number of respondents saw improving and worsening prospects. Data are seasonally adjusted and shown through February 2103.
SOURCE: Federal Reserve Bank of Dallas.

the second half of 2012 (*Chart 7*). The average index value in the second half was weakest for manufacturing. Overall, the three surveys anticipate positive outlooks, though not as much improvement as in early 2012.

State's Relative Strength

Texas should enjoy another good year in 2013, although job growth will likely be the same or moderately slower.

Private sector jobs in Texas expanded 3.7 percent after increasing 3.5 in 2011, exceeding the trend rate of 2.1 percent and the national pace of 2 percent. A significant bounce-back in government jobs in 2012 from sharp declines the year before helped overall job growth rise 3.1 percent from 2.3 percent in 2011.

However, private sector employment weakened in the second half of 2012 as a result of slowing in energy and manufacturing, as depicted in Chart 3. Continued expansion in construction should partially offset the decelerating trends in energy and exports.

Recent movements in leading indicators have been mixed, although the overall pattern of growth has been positive. Based on the recent momentum in job growth and changes in the Texas Leading Index, the Dallas Fed's forecasting model predicts that job growth this year will be between 2 and 3 percent.

Given expectations that the nation's economy will continue expanding only modestly, Texas will likely grow faster than most other states and the nation this year.

Phillips is a senior research economist and advisor at the San Antonio Branch of the Federal Reserve Bank of Dallas.

Notes

[1] See "Increasing U.S. Oil and Gas Production: Opportunities and Vulnerabilities," by Stephen P. A. Brown and Mine K. Yucel, prepared for the Council on Foreign Relations, January 2013.

[2] See "States Still Feel Recession's Effects Two Years After Downturn's End," by Jason Saving, Federal Reserve Bank of Dallas *Southwest Economy*, Fourth Quarter, 2011.

[3] See "Booming Shale Gas Production Drives Texas Petrochemical Surge," by Jesse Thompson, Federal Reserve Bank of Dallas *Southwest Economy*, Fourth Quarter, 2012.

[4] See "Texas Housing Market Finally Building a Solid Recovery," by D'Ann Petersen, Federal Reserve Bank of Dallas *Southwest Economy*, Third Quarter, 2012.

[5] For a more complete discussion of the energy markets, see "A Conversation with Michael Plante: Increased U.S. Energy Supply Helps Offset Tight Global Conditions," Federal Reserve Bank of Dallas *Southwest Economy*, Fourth Quarter, 2012.

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A Conversation with Marie T. Mora

Hispanic Workforce Faces Smaller but Persistent Education, Wage Gaps

Marie T. Mora, a past president of the American Society of Hispanic Economists, is an expert on labor-market issues, particularly along the U.S.–Mexico border. She is coauthor with Alberto Dávila of the forthcoming book Hispanic Entrepreneurs in the 2000s *and is a professor of economics and Vice Provost Faculty Fellow at the University of Texas–Pan American in Edinburg.*

Q. How do Hispanics fare in the labor market relative to other demographic groups?

Hispanics tend to trail non-Hispanics with respect to many—though not all—labor market measures. They earn less on average, tend to work in relatively low-skilled jobs, are less likely to have health insurance and experience higher unemployment rates than non-Hispanics.

To illustrate the earnings disadvantage, I estimate that Hispanics age 25 to 64 earned almost 33 percent less on average than non-Hispanics in 2010, based on the American Community Survey. However, it should be noted that most (28 percentage points) of this wage gap can be explained by education differences between the groups. The average schooling levels were 11.6 years among Hispanic workers versus 14.1 years among non-Hispanics. About 32 percent of Hispanic workers did not have a high school diploma or equivalent that year versus only 5 percent of non-Hispanics. Nearly 16 percent of Hispanic workers were college graduates, compared with 38 percent for non-Hispanics.

The unemployment rate among Hispanics was 9.8 percent—two percentage points higher than the 7.8 percent unemployment rate for the overall civilian workforce in fourth quarter 2012, according to the Bureau of Labor Statistics (BLS).

Despite Hispanics' higher unemployment rate, they had a higher employment rate—as measured by the employment/population ratio—at 59.6 percent versus the national average of 58.7 percent in fourth quarter 2012, according to BLS. They also had a higher labor force participation rate, 66.1 percent, compared with a 63.7 percent national average in the same quarter.

Most national surveys, including those conducted by the government, identify Hispanics simply through self-reporting. This means that anyone who claims he or she is Hispanic is counted as such. Moreover, when people report they are not Hispanic, they are excluded from the Hispanic population numbers even if they have Hispanic ancestry/national origin. This is an issue when it comes to tracking intergenerational progress.

Q. How do Hispanic employment patterns reflect the prevalence of the foreign born?

A relatively large share of immigrants among Hispanics affects employment patterns. According to my estimates, immigrants represented 58 percent of Hispanics age 25 to 64 but only about 12 percent of non-Hispanics in 2010. Because foreign-born Hispanics tend to have lower education levels and lower rates of English-language proficiency than their U.S.-born counterparts, many don't qualify for high-paying jobs.

It is, therefore, not surprising that foreign-born Hispanics earn less on average than their U.S.-born peers—28 percent less among workers age 25 to 64 in 2010. This immigrant/native earnings gap contrasts with the non-Hispanic foreign born, whose average earnings slightly exceeded those of U.S. natives in 2010.

With the datasets I use, I cannot determine who is unauthorized, but legal status is another factor likely affecting foreign-born Hispanics' employment opportunities. The Pew Hispanic Center estimates that almost 60 percent of all unauthorized immigrants in the U.S. in 2010 were from Mexico.

Q: What role does Hispanic entrepreneurship play?

Entrepreneurship has become increasingly important in shaping Hispanic labor market performance. The number of Hispanic-owned businesses rose from 1.6 million to 2.3 million firms between 2002 and 2007, the most recent Survey of Business Owners found. This 43.7 percent growth is more than triple the 14.5 percent rate for non-Hispanic-owned firms.

Moreover, my upcoming book coauthored with Alberto Dávila (*Hispanic Entrepreneurs in the 2000s*) notes such changes are not merely the result of a rapidly growing population. Within the Hispanic population, entrepreneurial tendencies have also intensified. For example, we found that self-employment rates of Hispanic workers age 25 to 64 rose from 7.9 percent to 9.1 percent between 2000 and 2010. During that period, these rates fell among non-Hispanics.

Even during the Great Recession, the self-employment rates of Hispanic immigrants rose, which was not the case for Hispanic natives. This indicates that many foreign-born Hispanics have been generating employment in the U.S., at least for themselves, even amid weak labor market conditions.

Q: Does the Hispanic education deficit vis-à-vis other groups dissipate over time?

Although Hispanic educational attainment has lagged behind that of non-Hispanics, the gap has narrowed.

"In 2010, Hispanics represented 1 out of every 3 workers in Texas, compared with approximately 1 out of 8 outside of the state."

For example, between 2000 and 2010, the share of Hispanic workers age 25 to 64 without a high school diploma or equivalent fell from nearly 4 out of 10 to 1 out of 3, while the proportion of college graduates rose from 13 to 16 percent. These numbers translated into an increase in average schooling levels from 11 years to 11.6 years, exceeding non-Hispanic workers' gain from 13.8 to 14.1 years.

A disproportionate presence of immigrants doesn't fully explain Hispanics' lower average schooling. U.S.-born Hispanics also trail non-Hispanics with respect to educational attainment and other socioeconomic measures, including earnings. In 2010, for example, among U.S.-born workers age 25 to 64, about 12 percent of Hispanics were high-school dropouts, compared with 5 percent of non-Hispanics. Within that same overall age group of workers, 22 percent of Hispanics were college graduates versus 36 percent of non-Hispanics. Overall, Hispanic natives averaged almost a year less of education than their non-Hispanic peers—13.2 years versus 14.1.

Such differences largely explain why U.S.-born Hispanics' earnings are relatively low. On average, they made nearly 16 percent less than U.S.-born non-Hispanics in 2010. When accounting for differences in education, the wage gap shrinks to 5 percent. It is also worth noting that this earnings differential among U.S.-born workers is smaller than the one that exists for the foreign born. In 2010, Hispanic immigrants earned about 47 percent less on average than non-Hispanic immigrants. Even when controlling for education, the gap remains considerable at 20 percent.

Q. How does Hispanic labor market performance in Texas compare with Hispanic outcomes elsewhere in the country?

The Hispanic population in Texas is proportionately more than twice as large as in the nation overall. In 2010, Hispanics represented 1 out of every 3 workers in Texas, compared with approximately 1 out of 8 outside of the state.

Texas Hispanics, as a group, tend to lag behind their counterparts in the rest of the country, earning 9 percent less on average in 2010. Among non-Hispanics, average wages were similar within and outside Texas, at least in 2010. Immigration does not appear to explain the relatively low earnings of Texas Hispanics. Immigrants represented 47 percent of Hispanic workers in Texas in 2010, compared with 60 percent in the rest of the country.

In terms of education, combining immigrants and U.S. natives, the average schooling levels of Texas Hispanic workers (at 11.5 years) in 2010 just slightly trailed those in other states (11.6 years). Statistically, this difference accounted for 1 percentage point of the Texas/non-Texas wage gap.

At the same time, education disparities between Hispanic Texans and non-Texans became more apparent, separating U.S. natives from immigrants. For example, in 2010, U.S.-born Hispanic workers age 25 to 64 in Texas had an average of 12.8 years of education—a half-year less than U.S-born Hispanics in other states. The average education of foreign-born Hispanic workers in Texas was 0.6 years less than the level of their peers in other states that year.

It is worth noting that Mexican–Americans represent a considerably higher share of Hispanic workers in Texas (86 percent) than Hispanics in the rest of the nation (56 percent). Puerto Ricans, who account for 1 out of 10 Hispanic workers outside of Texas, represent fewer than 2 percent of these workers in the state. It follows that the socioeconomic and demographic makeup of the Hispanic population in Texas differs from that of the nation as a whole.

Q. What are the biggest obstacles facing Hispanic youths today? What can be done to improve their chances of success?

Even though Hispanics have narrowed the education gap with non-Hispanics, educational attainment remains a major obstacle. It has become quite difficult to find a good-paying job without a four-year college degree.

Because Hispanics have less schooling on average than non-Hispanics—even among U.S. natives—it is likely they will continue to trail their non-Hispanic counterparts with respect to labor market income and many other socioeconomic indicators. And because Hispanics are less likely than non-Hispanics to complete high school—or, according to Pew, earn a general educational development (GED) degree—disproportionate numbers of Hispanic youths remain ineligible to go to college. Addressing high-school completion rates might be a way to improve the longer-term college graduation rates.

Importantly, these obstacles don't just affect Hispanic communities. Given the size of the Hispanic population, its economic well-being affects the nation as a whole. The economic impact of Hispanics is even greater in states such as Texas, where their presence is considerably stronger than the national average.

Mexico Develops Niche Approach to Expansion of Banking Services

By Edward C. Skelton

The new charter lowers barriers to market entry in Mexico at a time when many other countries are making the banking industry less inviting.

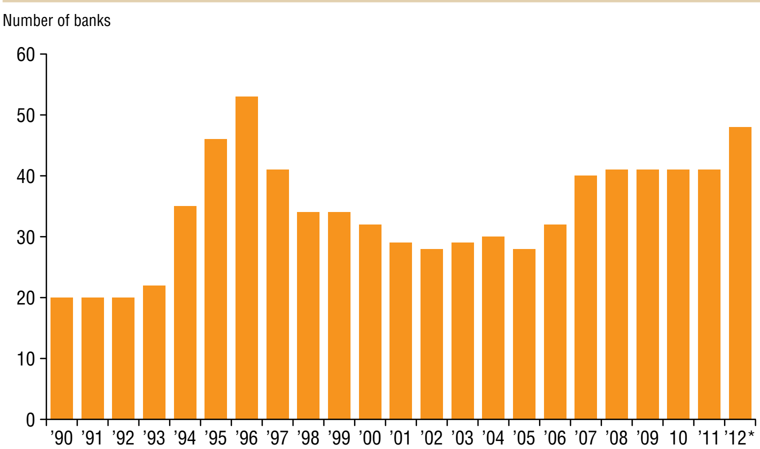
Mexico, a country where small business is still largely conducted without full financial system support, is looking to a creative solution to the problem—the niche banking charter. This emerging class of banks is an attempt by authorities to address a weakness in a financial system whose newfound resilience is in stark contrast to its historic volatility.

Niche banks are required to focus on a specific market or geographic region and operate using a simpler structure with a lower startup investment than for a full commercial bank. The new charter lowers barriers to market entry in Mexico at a time when many other countries are making the banking industry less inviting.[1]

Niche banking provides a recent example of Mexican authorities' efforts to build a world-class financial system that helps improve living standards. Financial institutions generally facilitate a country's overall growth and development, and niche banks may contribute much as community banks in the U.S. do with their local business focus.

These new institutions mark what appears to be a third wave of bank entrants into Mexico's financial system (*Chart 1*). The first two waves were in 1993–95 and 2006–07.

Chart 1 Interest in Bank Charters Growing Again in Mexico



*Three additional banks are in the process of applying for a charter.
SOURCE: Comisión Nacional Bancaria y de Valores.

Privatization and Crash

Commercial banks were nationalized in 1982 following a peso devaluation and financial system crisis. Of the 20 banks operating prior to privatization in 1991–92, 18 were government controlled. (Only Banco Obrero and Confia, a subsidiary of Citibank, were privately owned.)

When the government auctioned off its banks, investors typically paid a premium that averaged 3.5 times book value—by comparison, U.S. banks were selling for about 1.5 times book at that time. Purchasers anticipated limited competition, with profits remaining high. Those expectations were dashed in 1993 when the government began licensing new banks. In 1993 and 1994, 16 locally owned commercial banks began as de novo, or newly chartered, operations. Additionally, 17 foreign institutions opened commercial banks in Mexico by 1996.

The local banks aggressively extended credit in an attempt to generate the returns necessary to cover the high auction prices that purchasers had paid. With little lending experience, the banks were limited in their ability to assess credit and market risk.[2] Risky loans became more precarious by year-end 1994 as the peso collapsed and inflation and interest rates rose sharply. When borrowers struggled to repay debts the next year, the banks' financial condition severely deteriorated.

Failures and consolidation reduced the number of institutions in Mexico from 53 in 1996 to 34 in 1998. Most of the

Table 1

Banks Extend Their Reach in Mexico

Year	Branches	ATMs	Correspondents
2007	9,459	29,333	n.a.
2008	10, 726	29,640	n.a.
2009	10,736	33,648	n.a.
2010	11,294	35,942	9,303
2011	11,786	36,803	21,071
2012	12,338	39,830	*

*Data not yet available for 2012.

NOTES: Data for branches and ATMs in 2012 are as of November. Correspondent arrangements allow commercial banks to deliver basic services through businesses such as retail stores.

SOURCES: Comisión Nacional Bancaria y de Valores; Banco de México.

survivors were zombie banks, open only because of regulatory forbearance and government support. Ultimately, taxpayers paid about US$100 billion, or 17 percent of gross domestic product (GDP), to recapitalize the banking system. By comparison, the Federal Deposit Insurance Corp. estimates the savings-and-loan crisis of the 1980s cost U.S. taxpayers $124 billion, or 2.1 percent of GDP.[3] The Mexican financial system stagnated for a decade as the banks rebuilt balance sheets and strengthened their capital bases. Loan growth didn't resume until early 2005, when the banks returned to more usual operations, clearing the way for new charter activity.[4]

Niche Banks' Emergence

Authorities sought to increase financial penetration in the country, which they felt was underserved—constrained by geography and perceived high costs for consumer banking products.[5] A 2006 World Bank survey found that fewer than 25 percent of Mexican households possessed any type of formal financial product.

Efforts focused on expanding banks' geographic reach and reducing the cost of services by increasing competition and promoting the entry of new institutions. Fourteen new commercial banks were chartered from May 2006 to year-end 2007. Seven of the de novo banks' target markets were previously unbanked low- to middle-income households. Four of these seven banks were affiliated with retailers and focused on offering basic checking accounts, savings accounts and consumer loans in stores. Lower-income households, in particular, gained expanded access to finance. Existing banks also increased their geographic reach, making basic financial services available through businesses such as pharmacies and convenience stores in what are known as correspondent arrangements (*Table 1*).[6]

A Slow Start

During the pickup in de novo banks, the niche bank charter emerged.[7] Among the features of the new charter are its concentration on specific markets, reduced start-up costs, ease of entry into the banking industry and improved regulatory coverage for the financial system.

The new charter, introduced with some fanfare, did not catch on initially. In 2008, as the financial crisis roiled global financial markets, Mexican institutions retrenched. The national economy contracted more than 6 percent in 2009, suffering fallout from the U.S. recession.[8] Institutions potentially interested in niche bank charters deferred action until after the economy recovered in 2010.

The overall application process for niche banks mirrors that used for commercial banks. The first step is a business plan and application submission. The Comisión Nacional Bancaria y de Valores (CNBV), Mexico's financial regulator, authorizes the entity to organize. The entity must then establish its main operational areas: loans, funding and treasury services, capital adequacy, risk management, technological infrastructure, anti-money-laundering measures, accounting processes, internal controls and basic security measures.

After an operational infrastructure is installed, the CNBV performs a preoperative on-site examination. It tests and evaluates the resources, obligations and assets, and operations, performance and control systems of the institution. If the entity gets a passing grade, the regulator grants a banking license and operations can begin.

The process took about two years for the first two niche banks—Banco Agrofinanzas, focused on the agricultural sector, and Banco Bicentenario, concentrating on trade finance. Both banking licenses were approved in July 2012.

Niche Bank Surge

Six new banks were chartered, including four as niche banks, in the second half of 2012. CNBV also announced that three more banks have formally applied for a niche bank license, with two of them undergoing the preoperative on-site examination. Those banks are expected to receive a license in first quarter 2013. Table 2 shows niche banks that have either been licensed or have received initial authorization to form and are in the preoperative examination process.

Agricultural and cross-border businesses seem to offer especially attractive opportunities. The CNBV indicated that at least three other groups have completed the due-diligence process but haven't yet formally applied for a banking license.

Ordinary commercial banks, formally called "banca múltiple," must raise at least 439 million pesos ($33.9 million) in capital to open.[9] Recent de novo commercial banks suggest that the minimum investment is a binding constraint. Of the 16 commercial charters granted since 2006, nine came within 50 million pesos ($3.9 million) of the minimum startup capital investment and three were within 100 million pesos ($7.7 million). Lowering the minimum start-up cost would spur bank creation.

Within the niche charter, there are two types of niche banks, each with a different capital requirement (*Table 3*). Larger niche banks must raise at least

The goal of Mexico's smaller niche banking charter is to increase availability of simple checking and savings accounts. The institutions also generate cheaper funding by attracting deposits.

Table 2 Niche Banks' Niches

Institution	Niche	Former charter	Date license approved
Banco Agrofinanzas	Agriculture	*Sofol*	July 2012
Banco Bicentenario	Export-import/trade finance	Credit union	July 2012
Banco Forjadores	Microfinance, specifically female entrepreneurs	*Sofom*	September 2012
Banco Pagatodo*	Payment systems	No financial system charter	September 2012
Corporación Financiera de Occidente (Finox)	Agriculture	*Sofol*	Pending
Unión de Crédito Progreso	Region encompassing the state of Chihuahua	Credit union	Pending

*Pagatodo operates under the smaller niche bank charter and is unable to lend directly to households or businesses.

NOTES: A *sofol* is a regulated finance company; a *sofom* is an unregulated finance company. In addition to these niche banks, two new commercial banks, Banco Inmobiliario Mexicano and Fundación Dondé Banco, were approved for a banking license in November 2012.

SOURCE: Federal Reserve Bank of Dallas.

263 million pesos ($20.3 million), while smaller niche banks must raise 175 million pesos ($13.5 million). In general, the larger banks cannot engage in trust activities, while the smaller banks cannot lend, except to other banks, and are limited in their ability to use the market for funding. In the U.S., an institution must lend to be considered a bank.

The goal of Mexico's smaller niche banking charter is to increase availability of simple checking and savings accounts. The institutions also generate cheaper funding by attracting deposits. To date, only one of the approved niche banks has chosen to operate under the lower startup capital requirement.

Mexican regulatory authorities are eliminating an existing financial system charter, further spurring the formation of niche banks. Each Sociedad Financiera de Objeto Limitado (*sofol*), or regulated finance company, must become a bank or an unregulated finance company (*sofom*) by July 2013. *Sofoles* specialize in offering credit to a specific market segment, making them a natural fit for a niche bank charter. The question is whether the ability to accept deposits is worth the regulatory compliance costs.

Of the 21 active *sofoles*, one has already launched a niche bank, a second is in the process of getting a niche bank charter and a third has purchased a commercial bank. The other *sofoles* focus on mortgages, as well as education, small business and agricultural lending.

Gaining Access

Mexico's high level of informality contributes to the low banking penetration, with commercial banks not fully tapping many segments of the economy. This leads to less access to credit and greater self-financing. Niche banks can address the issue by bringing more households and businesses into the formal banking system.

Much of the Mexican population still relies on informal finance—largely escaping taxes and the reach of the law. About 44 percent of Mexican households were outside the formal financial system in 2012, according to a survey by CNBV and the Instituto Nacional de Estadística y Geografía (Mexico's National Institute of Statistics and Geography).[10] More than half of Mexico's labor market is informal.[11] Still, many of these households earn steady salaries and could benefit from financial inclusion.

Moreover, small businesses continue to have trouble getting credit. At the beginning of 2013, only 35 percent of Mexican businesses with fewer than 100 employees had outstanding bank credit, compared with 54 percent of larger businesses, a quarterly Banco de México survey found.[12] More than half of the small businesses felt that banks were unwilling to offer them credit.

By focusing on a specific market or region, niche banks may be better equipped to reach small businesses and help them serve as an engine for the

Table 3 Permissible Activities by Niche Charter

Activity	Small niche bank (175 million-peso threshold)	Large niche bank (263 million-peso threshold)
Accept deposits	Yes	Yes
Issue bank bonds	No	Yes
Issue subordinated debentures	No	Yes
Make loans	Interbank only	Yes
Issue credit cards	No	Yes
Offer trust services	Yes	No
Receive deposit administration, custody or guarantees for third parties of titles or securities	Institutional investors or companies only	Yes
Offer leasing and factoring products	No	Yes
Derivatives (hedging only)	No	Yes
Engage in transactions involving precious metals or foreign currencies	Yes	Yes

SOURCE: Comisión Nacional Bancaria y de Valores.

country's overall growth and development. Within the U.S., smaller banks tend to focus on business lending, particularly to small businesses, and maintain a flow of credit to small businesses even during difficult times.[13]

Improved access to formal finance could help reduce the level of informality. For this to happen, however, the benefits of formality must exceed the costs of paying taxes and conforming to business regulations.

Potential Pitfalls

While niche banks lower barriers to entry and are able to focus on a specific market or geographic area, they face potential headwinds.

One concern is they must comply with the same prudential regulations and risk-based capital requirements as commercial banks and are subject to both on-site examinations and off-site monitoring. Their smaller size suggests regulatory burdens could be relatively greater. The burden would be spread across fewer assets and could result in disproportionate oversight expenditures. In turn, these higher compliance costs could be passed on to customers through increased prices or reduced service.

Another concern is that niche banks' exposure to a specific industry or region could make diversification difficult. Individual institutions are vulnerable to regional or industry downturns. Moreover, the institutions' small size could make it hard for them to obtain funding or recapitalize in tough times.

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Notes

[1] See "Regulatory Burden Rising," by Christoffer Koch, in "Financial Stability: Traditional Banks Pave the Way," Federal Reserve Bank of Dallas Special Report, January 2013, www.dallasfed.org/microsites/fed/annual/2012/e4/w1201e4.cfm.

[2] For a detailed account of the banking system's privatization and the foundation for the resulting crash, see "Liberalization, Privatization and Crash: Mexico's Banking System in the 1990s," by William C. Gruben and Robert McComb, Federal Reserve Bank of Dallas *Economic Review*, First Quarter 1997, pp. 21–30.

[3] "Cost of the Savings and Loan Crisis: Truth and Consequences," by Timothy Curry and Lynn Shibut, Federal Deposit Insurance Corp., *FDIC Banking Review*, December 2000. U.S. GDP as of December 1990 was used in the denominator. Although the crisis was over by 1990, the costs were spread over several years into the 1990s.

[4] For more detail, see "Mexico Emerges from 10-Year Credit Slump," by Robert V. Bubel and Edward C. Skelton, Federal Reserve Bank of Dallas *Southwest Economy*, May/June 2005, and "Financial Globalization: Manna or Menace? The Case of Mexican Banking," by Robert V. Bubel and Edward C. Skelton, Federal Reserve Bank of Dallas *Southwest Economy*, January/February 2002.

[5] See "Reaching Mexico's Unbanked," by Edward C. Skelton, Federal Reserve Bank of Dallas *Economic Letter*, vol. 3, no. 7, 2008.

[6] The Asociación de Bancos de México estimates correspondent banks have been growing 7.8 percent a month since they were introduced in October 2010.

[7] Formally, the charter is called "banca múltiple con objeto social acotado," or limited purpose commercial bank.

[8] For more detail on the 2009 recession, see "Mexico's *Año Horrible*: Global Crisis Stings Economy," by Erwan Quintin and Edward C. Skelton, Federal Reserve Bank of Dallas *Southwest Economy*, Third Quarter 2009.

[9] The capital requirement is indexed to inflation using Unidades de Inversión, or UDIs. UDIs are a unit of account pegged to Mexico's official inflation rate. The minimum startup capital is UDI90 million for a commercial bank, UDI54 million for a large niche bank and UDI36 million for a small niche bank. As of Dec. 31, 2012, a UDI was worth 4.88 pesos, and the exchange rate was 12.9658 pesos:$1.

[10] The survey "Encuesta Nacional de Inclusión Financiera" as well as data measuring households' access to and use of financial services is published by CNBV.

[11] The most cited statistic is that, as of fourth quarter 2012, informal workers made up 59.9 percent of Mexico's labor market. Informal workers include those outside the country's social security system, subsistence farmers, those working for unregistered businesses, and other individuals who do not pay taxes. See "Resultados de la Encuesta Nacional de Ocupación y Empleo," published by the Instituto Nacional de Estadística y Geografía, for more information about the country's labor market conditions.

[12] See "Evolución Trimestral del Financiamiento de las Empresas," published quarterly by Banco de México.

[13] In the U.S., community banks held 17 percent of all banking system assets but accounted for more than half of all small business loans as of June 2012. See "A Lender for Tough Times," by Jeffery W. Gunther and Kelly Klemme, in "Financial Stability: Traditional Banks Pave the Way," Federal Reserve Bank of Dallas Special Report, January 2013, www.dallasfed.org/microsites/fed/annual/2012/e2/w1201e2.cfm.

PORTS: Longshoremen Wield Hefty Collective Bargaining Power

Recent labor negotiations involving ports on the Gulf and East coasts—including the Port of Houston—underscored the bargaining strength of longshoremen, the workers responsible for loading and unloading ships.

Containerized cargoes were a key point of the talks. Container royalty payments began in the 1960s to compensate longshoremen for jobs lost with the introduction of cargoes shipped in steel boxes, rather than in bulk. The containers are transferred from ship to shore with cranes instead of longshoremen's labor. The International Longshoremen's Association union captured some of the benefits of the more efficient system with the royalty, a container charge that workers will largely retain under a new agreement.

The United States Maritime Alliance had argued that the royalty has grown beyond its original purpose and effectively serves as a "bonus" averaging $15,500 annually for these workers, whose typical $50 hourly pay is itself more than twice the average wage of all union workers.

Pay and benefits for longshoremen have historically been high, reflecting negotiating clout that comes with the ability to halt the valuable flow of cargo through the nation's ports. International trade is equivalent to about 25 percent of the nation's gross domestic product. Texas sea ports handle 19 percent of total U.S. port tonnage.

—Melissa LoPalo

INSURANCE: Weather Pushes Texas to Highest Homeowners' Premiums

Homeowners' insurance rates have been higher in Texas than elsewhere in the United States for most of the past 10 years, according to recent data from the National Association of Insurance Commissioners. The most commonly issued policy cost $1,560 in Texas in 2010, 72 percent more than the national average of $909.

High premiums in Texas appear odd because home values and, therefore, the amount insured are relatively lower in Texas than in the U.S. Nearly 40 percent of homes are insured for less than $150,000, compared with just over 20 percent nationwide, a 2012 Texas Department of Insurance study found.

Possible explanations for the comparatively high rates include the state regulatory framework, the average loss per policy and the exposure to catastrophes in Texas, according to the study. The study attributed much of the Texas differential to high average losses per policy due to the wide variety of weather-related catastrophes possible. Tornadoes, hail and hurricanes together leave insurers in Texas with long-term average losses per insurance policy that exceed the average premium in the U.S.

Within Texas, the highest insurance rates are along the hurricane-prone Gulf Coast. Florida experienced higher rates than Texas in 2007 following a record 2005 hurricane season.

—Christina Daly

SHALE OIL: Eagle Ford Likely to Overtake North Dakota's Bakken

South Texas' Eagle Ford shale is expected to surpass North Dakota's Bakken shale in oil production this quarter. The Eagle Ford, with production estimated at 419,000 barrels per day in December 2012 by the Texas Railroad Commission, is quickly closing in on the Bakken, which produced 704,000 barrels per day in December, according to the North Dakota Department of Mineral Resources.

The Eagle Ford and Bakken shale formations differ slightly. The Eagle Ford is 50 miles wide and 250 feet thick on average, at a depth of 4,000 to 12,000 feet, according to the commission. The Bakken, which extends into Montana and Canada, is 150 feet thick at a depth of 3,100 to 11,000 feet. Technically recoverable oil resources as of Jan. 1, 2009, were 3 billion barrels for the Eagle Ford and 4 billion barrels for the Bakken, according to the U.S. Energy Information Administration.

Production costs also vary between the two. Eagle Ford producers need $50 per barrel to break even; for the Bakken, it's $44. Eagle Ford and Bakken production are expected to increase, though the additional Bakken output will likely require rail transport at $3 to $5 per barrel over the cost of shipment via pipeline, creating a disincentive to expand at Bakken, the International Energy Agency said.

—Amy Jordan

Out of the Shadows: Worker Pay, Benefits Could Rise with Immigration Law Revamp

By Pia Orrenius, Michael Weiss and Madeline Zavodny

Immigration reform, with the support of the president, is back before a Congress that may be ready to consider new measures. If a legalization plan can be crafted, it would likely far exceed the magnitude of the only other such large-scale effort, the Immigration Reform and Control Act (IRCA) of 1986.

A comprehensive legalization program would reflect the unprecedented scale of the unauthorized workforce today. Whereas 1.7 percent of the labor force took advantage of the 1986 program, the undocumented now make up over 5.2 percent of U.S. workers and number 1.8 million in Texas alone.

The main economic effect of legalization would be higher earnings for those who become legal. Latin American legalized immigrants' wages increased 6 to 13 percent after IRCA, with slightly larger effects among women than men.[1]

Legalization removes employers' risk of incurring penalties and allows immigrants to move to better, higher-paying jobs. It also could lead to additional illegal and legal immigration—which characterized the previous U.S. experience (*see chart*). Some benefits traditionally associated with unauthorized workers would dissipate with legalization. Employers, particularly in sectors of the economy that depend on a steady stream of such labor, benefit from people willing to hold any job, even undesirable ones, that pay low wages. Consumers enjoy lower prices for goods and services. The immigrant wage increase that would occur after an amnesty is effectively a transfer to the newly legalized workers from employers and consumers.

The impact on citizens is mixed. Labor market outcomes may worsen for natives and other immigrants if newly legalized immigrants compete more closely with them for jobs. However, compliance with tax withholding and labor regulations—from minimum wage laws to health and safety regulations—would likely increase and level the playing field by erasing some cost advantages of illegal immigrant workers.

On the tax side, income and payroll tax revenues are expected to increase as some workers paid under the table move onto the books. However, estimates suggest that over half of unauthorized immigrants already pay income and payroll taxes through withholding, filed tax returns or both.[2]

On the spending side, most of the short-run impact would involve the U.S. citizen children of newly legalized individuals. These minors are already eligible for means-tested benefits, such as the Children's Health Insurance Program, if family income is low enough but often aren't enrolled because of deportation fears.

There would be an added social benefit— greater family income and stability. Research indicates that Mexican–American young adults living in the United States complete more years of school, score higher on standardized tests and learn better English if their parents gain legal status.[3]

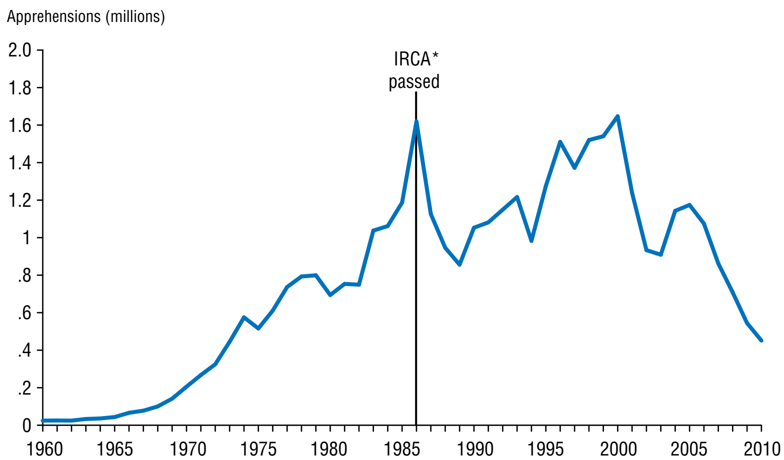
Notes

[1] See "Gender Differences in the Labor Market: Impact of IRCA's Amnesty Provisions," by Catalina Amuedo-Dorantes, Cynthia Bansak and Steven Raphael, *The American Economic Review*, vol. 97, no. 2, 2007, pp. 412–16, and "Legalization and the Economic Status of Immigrants," by Silvia H. Barcellos, RAND Corp., RAND Working Paper no. WR-754, March 2010, www.rand.org/content/dam/rand/pubs/working_papers/2010/RAND_WR754.pdf.

[2] See "The Impact of Unauthorized Immigrants on the Budgets of State and Local Governments," Congressional Budget Office, December 2007. Unauthorized workers use a variety of means to comply with tax laws. Some have been issued an Individual Taxpayer Identification Number (ITIN) or a Social Security number that is invalid for work, while others use fake numbers or numbers that belong to somebody else. Until the early 2000s, there were few consequences for workers who submitted false or fraudulent Social Security numbers.

[3] See "The Economic Consequences of Amnesty for Unauthorized Immigrants," by Pia M. Orrenius and Madeline Zavodny, *Cato Journal*, vol. 32, no. 1, 2012, pp. 85–106.

Border Patrol Apprehensions Along the Southwest Border



*Immigration Reform and Control Act.

SOURCE: U.S. Department of Homeland Security, Enforcement Case Tracking System and Performance Analysis System; Statistical Yearbook of the Immigration and Naturalization Service (various years); "Apprehensions by the U.S. Border Patrol: 2005–2010," by Lesley Sapp, Office of Homeland Security, 2011; "Immigration Enforcement Actions: 2011," by John Simanski and Lesley Sapp, Office of Homeland Security, 2012.

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SNAPSHOT Fewer 'Acute Risks' Strengthen Global Outlook

Cautious optimism may be warranted for the 2013 global economic outlook because "acute risks" have decreased amid the easing euro zone sovereign debt crisis, according to International Monetary Fund (IMF) Chief Economist Olivier Blanchard.

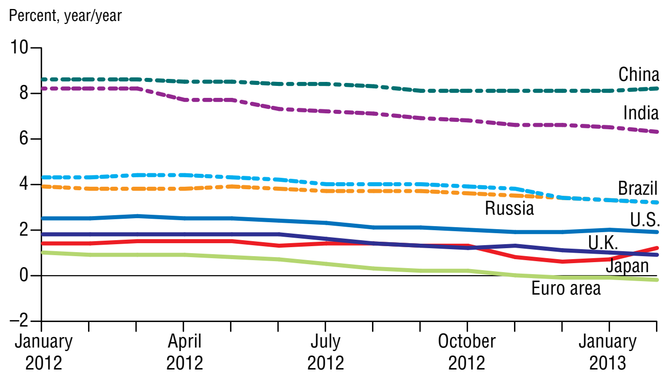
The IMF, in a forecast released in January, said it anticipates 2013 global gross domestic product (GDP) growth of 3.5 percent, up from 3.2 percent in 2012. World economies should grow 4.1 percent in 2014.

"The euro area continues to pose a large downside risk to the global outlook," the IMF said, well before recent bank difficulties in Cyprus.

Forecasts continue to point to emerging economies as drivers of world growth, with advanced economies lagging behind. Expectations of 2013 growth remained stable for most advanced economies in the first half of 2012 and then fell slightly through the second half. The declines generally leveled off in January, with a slight uptick in Japan (*see chart*). In spite of the initial report of decreased U.S. GDP in fourth quarter 2012, annual growth held steady at 2.2 percent, up from 1.8 percent in 2011.

—Adapted from the International Economic Update, Federal Reserve Bank of Dallas

Forecasts for 2013 Real GDP Growth Stabilizing



SOURCE: Consensus Economics Inc.'s *Consensus Forecasts.*

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