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# Southwest Economy

FEDERAL RESERVE BANK OF DALLAS

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**Mexico's  
*Año Horrible:*  
Global Crisis  
Stings Economy**

# President's Perspective



*At the Dallas Fed, we take great pride in our ability to keep tabs on the state economy.*

Texas stumbled into recession last fall, about a year behind the nation as a whole. As hard as it has been hit, the state has fared better than most of the rest of the country during this downturn. Job losses have been less severe. Housing markets haven't suffered as much.

In good times or bad, economic conditions in Texas are not the same as they are in other parts of the country. At the Dallas Fed, we take great pride in our ability to keep tabs on the state economy, serving as the Federal Reserve's eyes and ears in this part of the country.

Over the years, our Research Department has developed specialized analytic tools to delve deeper into the Texas economy's ups and downs. I regard these tools as a key aspect of the Dallas Fed's franchise—resources not only for me and my colleagues on the Federal Open Market Committee but also for the public at large, including businessmen,

researchers and policymakers.

The monthly Texas Leading Index combines a handful of region-specific measures to anticipate changes in the state business cycle. Since its inception in 1988, this index has produced an impressive track record when used in a forecasting model. The Dallas Fed's job growth projections, based on this leading index, have been included in the Western Blue Chip Economic Forecast for 15 years.

Every quarter, our regional group produces an early benchmark of Texas payroll employment data—a calculation the Bureau of Labor Statistics releases only once a year. Over time, these estimates have been on the money, providing timely and accurate estimates of Texas labor market conditions.

Since May 2004, our regional group has conducted the Texas Manufacturing Outlook Survey. Released on the last Monday of every month, it summarizes respondents' views of current and future business activity. Swings in this sector often prove useful for understanding the overall economy, so local and national news agencies regularly cite the survey's results.

In this issue's "On the Record," four of our regional analysts give an update on Texas' economy, sharing with you the kind of insight they provide to me on a daily basis. If I may sum up their message: The Texas economy is in recession, but some hopeful signs have been emerging in recent months.

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



# Mexico's *Año Horrible*: Global Crisis Stings Economy

By Edward C. Skelton and Erwan Quintin

*Over the past few months, optimism has been replaced by increasingly dire predictions for the country's near-term economic outlook.*

Until last September, the global economic slump was expected to take a fairly limited toll on the Mexican economy. There was even talk of decoupling—that, for once, a U.S. recession would leave Mexico relatively unscathed. Over the past few months, however, this optimism has been replaced by increasingly dire predictions for the country's near-term economic outlook.

This deterioration is hardly surprising. The global crisis intensified markedly in September 2008, and the true magnitude of the slowdown began to emerge. World trade flows dried up, which is particularly damaging for nations like Mexico whose economic activity depends critically on exports. At the same time, international financial uncertainty led investors to withdraw capital from emerging markets.

As if that weren't enough, Mexico was confronted with a number of idiosyncratic shocks: a crackdown on drug cartels and local corruption, a flu epidemic and trade

disputes with its most important partner. The result of this confluence of bad news and bad luck is that Mexico is experiencing a truly horrible 2009.

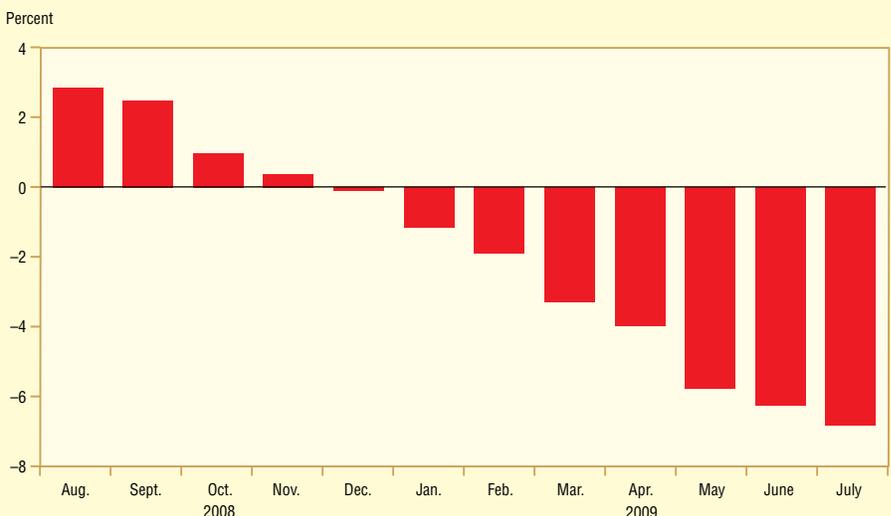
But even this darkest of clouds has a silver lining. Twenty years ago, circumstances such as these almost surely would have caused a financial collapse in Mexico. To date, none has occurred. In fact, recent data suggest the financial system is exhibiting stability even as a severe recession plagues the country. This resilience demonstrates the strides Mexico has made toward reducing its financial vulnerability.

## Anatomy of a Recession

Officially, the U.S. recession began in December 2007. Yet, Mexico's economy continued to expand for much of 2008. Through November of that year, most forecasts for 2009 gross domestic product (GDP) growth called for Mexico to avoid recession (*Chart 1*). Forecasters cited Mexico's strong

Chart 1

### Forecasts Point to Deteriorating Mexico GDP Growth (Projections for full-year 2009 as of each month)



SOURCE: Banco de México, Survey of Private Sector Analysts.

macroeconomic fundamentals and lack of exposure to the problems afflicting the U.S. and Europe.

Forecasts of decreasing economic activity gained momentum after the beginning of 2009. Since then, however, forecasts for growth have tumbled well into negative territory. Mexico's economy is now expected to contract by over 6 percent this year.

Recent data support this pessimism. Surprisingly resilient for a while, Mexican exports plunged—as they inevitably do when U.S. manufacturing activity weakens (*Chart 2A*). This is a big reason Mexico, together with other trade-dependent nations

such as Germany and Japan, now ranks among the countries hardest hit by the global slump. When exports collapse, industrial output is never far behind. Despite talk of possible decoupling last year, Mexico is once again tracking the U.S. almost step for step in industrial output (*Chart 2B*).

Weakening economic activity has accelerated job destruction. As tends to be the case during severe contractions, employer-initiated job terminations are rising (*Chart 3*). Recent research has demonstrated the importance of this indicator.<sup>1</sup> During tranquil times, job flows are a natural part of well-functioning labor markets. During deep

*Mexico, together with other trade-dependent nations such as Germany and Japan, now ranks among the countries hardest hit by the global slump.*

**Chart 2**  
**Exports and Industrial Production Plummet**

**A. Mexican Exports**

Index, January 2008 = 100



**B. Industrial Production**

Index, January 2008 = 100



SOURCES: Instituto Nacional de Estadística y Geografía; Banco de México; Haver Analytics; Federal Reserve Board.

slumps, however, many workers are forced to move to occupations and sectors for which their skills may be ill-suited, resulting in productivity losses.

Further cutting into growth in Mexico is the weak labor market in the U.S. Money sent home by Mexican workers in the U.S., called remittances, plunged 20 percent in the 12 months ending in May. The impact fell largely on poorer families.

A 2009 Banco de México survey pointed to a key factor in the falling remittances: Mexicans in the U.S. are disproportionately employed in sectors that have declined most dramatically, with construction a prominent example.<sup>2</sup>

Uncertain employment and income prospects, domestic shocks and the loss of help from relatives in the U.S. have greatly weakened Mexican consumer confidence and spending.

Unfortunately, consumers aren't the only ones cutting back. Domestic investment has dropped over 10 percent since October, which bodes ill for the country's near-term outlook. Even foreign direct investment, a typically resilient engine of Mexico's growth and one of Mexico's strong suits over the past two decades, is heading in the wrong direction.

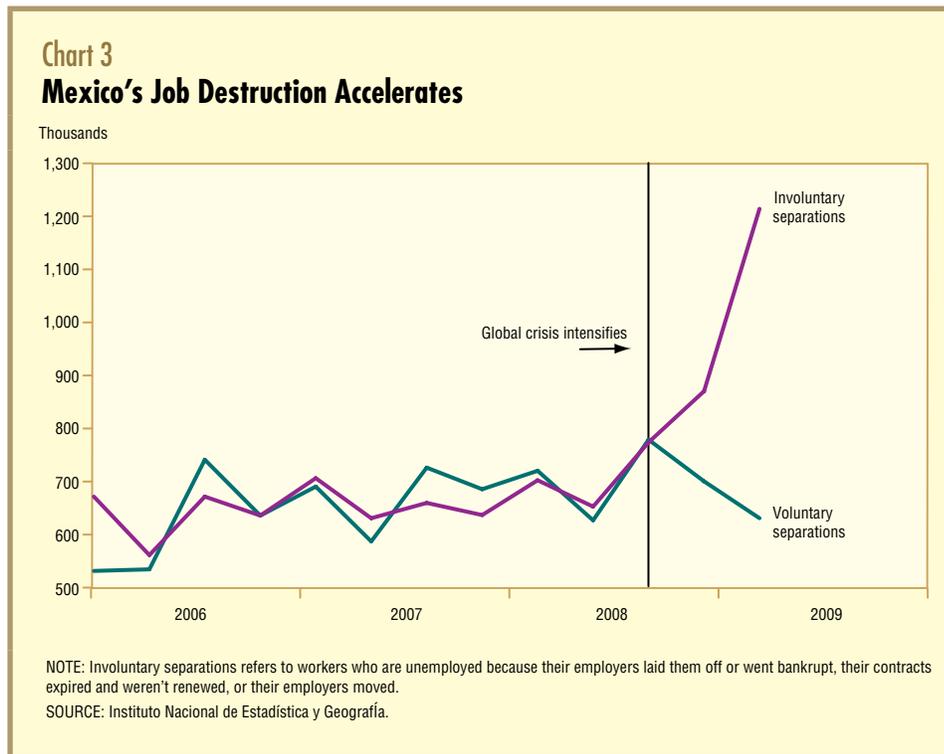
### 'Tequila'-Size Slump

This litany of depressing economic news made bad GDP numbers inevitable. Indeed, recent readings have been jaw-dropping.

The last quarter of 2008 seemed disastrous enough, with an annualized decline of 10 percent. But the pace of contraction more than doubled in the first quarter of 2009 (Chart 4). In the second quarter—a period affected by the swine flu scare—real output fell by 4.5 percent. The contraction has slowed, but it remains quite steep. Economic activity is 10 percent below its level at the same time last year.

To put things in historical perspective, Mexico hasn't experienced a GDP contraction like this since its infamous Tequila Crisis of the mid-1990s. The episode's name refers to the economic hangover that resulted from an abrupt drop in the peso's value. What worries some observers is that the magnitude of the current downturn isn't the only similarity with the Tequila Crisis.

Last fall, when the global economic picture took a turn for the worse, the peso suddenly collapsed as Mexico's borrowing costs soared. Between August and April, the peso lost 40 percent of its value vis-à-



vis the dollar, a depreciation not seen in Mexico since December 1994.

Also reminiscent of pre-Tequila tensions is the vast amount of foreign reserves the central bank is spending trying to contain peso pressures. Since the peso weakness began in October, the central bank has provided almost \$20 billion in liquidity to ease peso volatility.

Evidence of capital flight also materialized in the cost of the country's debt. The premium Mexico pays relative to comparable U.S. instruments more than tripled last fall. Although the initial spike has moderated, Mexican debt is still significantly more expensive than in recent years.

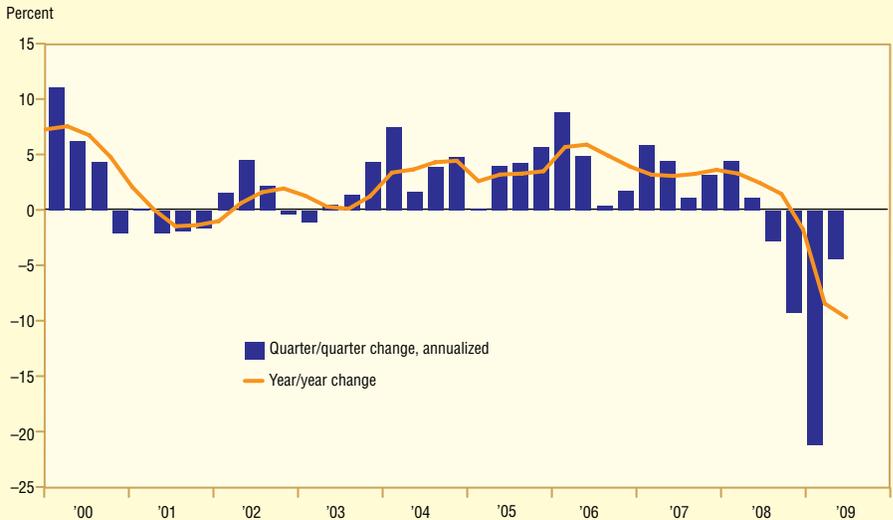
As a result of these financial disruptions, some firms have reported difficulties getting credit through standard means. The central bank, federal government and development banks have all taken steps to ensure businesses can obtain the working capital they need.

It's important to note that Mexico is not alone in this financial predicament. The response to last fall's global financial turbulence mirrors what often happens in a global crisis: Investors, perceiving heightened risk, pull their money out of emerging markets.

Currencies have depreciated sharply and country risk premia have risen since last August throughout the emerging world

*The last quarter of 2008 seemed disastrous enough, with an annualized GDP decline of 10 percent. But the pace of contraction more than doubled in the first quarter of 2009.*

**Chart 4**  
**Mexico's Real GDP Collapses**



SOURCE: Instituto Nacional de Estadística y Geografía.

*As recently as 20 years ago, the collection of real and financial shocks now confronting Mexico would have set off debt defaults and a banking crisis. To date, nothing of the sort has occurred.*

(Chart 5). In other words, there's nothing Mexico-specific about this capital flight.

More important, Mexico is in a far stronger position to deal with these shocks today than it was prior to the Tequila Crisis.

### Greater Policy Discipline

As recently as 20 years ago, the collection of real and financial shocks now confronting Mexico would have set off debt defaults and a banking crisis. To date, nothing of the sort has occurred.

Since the Tequila Crisis, Mexico has displayed a steadfast commitment to monetary and fiscal discipline.<sup>3</sup> This has enabled the country to stop relying on short-term, foreign-currency-denominated debt. It now routinely issues 10-, 20- and 30-year peso-denominated, fixed-interest bonds. As a result, Mexico no longer lives and dies with the mood swings of fickle foreign investors.

The banking sector is in much better shape than it was in the early 1990s, adding to the country's stability. Although currently on the rise, problem loans are a fraction of what they were even five years ago. And Mexico's banking system has little direct exposure to toxic assets.<sup>4</sup>

Mexico's banking system, in fact, bears little resemblance to what it looked like in 1994. At that time, the banks had just been privatized under a poorly designed auction process. In the five years leading up to the Tequila Crisis, credit quadrupled as a

share of GDP. Back then, Mexico's financial system lacked the type of regulatory, risk management and legal infrastructure necessary to support credit growth and a healthy financial environment.

In addition, banks were highly exposed to currency risks because many of their liabilities were denominated in U.S. dollars. The collapse of the peso in December 1994, together with jumps in interest rates and inflation, put tremendous stress on bank balance sheets, eventually leading to a full-blown banking crisis.

Experience is a harsh tutor, and Mexico learned the lessons taught by the earlier financial system collapse.<sup>5</sup>

Banks have lowered their exposure to currency movements by reducing their dollar borrowing. They also measure risk much more effectively than in the mid-1990s and are considered well-capitalized under international accounting standards. Furthermore, financial system authorities have spent a great deal of time and energy modernizing supervision. Transparency has greatly improved as financial authorities have implemented regulations and accounting practices consistent with, and in many cases more stringent than, international standards.<sup>6</sup>

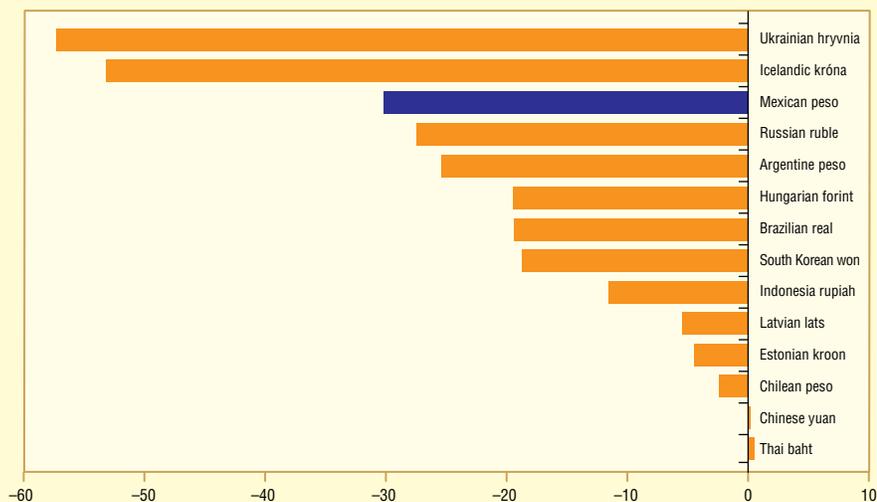
### Prospects for Improvement

When is Mexico likely to emerge from this deep recession?

For the most part, Mexico's troubles

## Chart 5 Investors Dump Emerging-Market Currencies in Quest for Liquidity

Percent change in value, August 2008–July 2009



NOTE: Base currency is U.S. dollars.

SOURCES: The central banks; *Financial Times*.

result from the global slump. Therefore, improvement should materialize when the global economy—and the U.S. in particular—begins to recover.

Most forecasters expect the world economy to shrink 1 to 2 percent this year, bringing about the first global recession since World War II.<sup>7</sup> Next year should bring positive, if small, numbers for world output growth. The U.S. economy is expected to contract 2 to 3 percent this year and grow at a slow pace next year.

The short-term outlook is worse for Mexico than the U.S. Because of its heavy reliance on exports and the country-specific shocks it's experiencing, the Mexican economy is expected to retreat 6 percent or more this year. Growth should turn positive by the end of 2009 but remain weak.

While Mexico awaits a turnaround in global economic activity, policymakers are trying to mitigate the effects of the contraction without compromising their dedication to policy discipline.

Mexico was slow to use monetary policy to respond to the deteriorating conditions because the weakening peso threatened price stability. Once the peso stabilized and inflation began to wane, the central bank aggressively lowered the overnight interest rate. The rate is down 375 basis points since January, leaving it at 4.5 percent.

Mexico responded more quickly with fiscal policy, passing a stimulus package at the

end of 2008. However, the government's fiscal challenges greatly constrain its ability to spend during downturns.<sup>8</sup> Mexico depends heavily on oil prices for revenue because its large informal economy limits its ability to raise taxes. Consequently, the eventual size of the stimulus package is likely to be rather small. After maintaining a near-balanced budget over the previous few years, Mexico's Congress approved a budget deficit of 1.8 percent of GDP for 2009.

Despite Mexico's *año horrible*, the country's remarkable efforts to reduce its financial vulnerability have enhanced its ability to deal with large economic shocks. Mexico's economy has been bloodied but has avoided collapse, thanks to prudent policymaking and a much improved financial system.

At the same time, Mexico has yet to address many areas of vulnerability. The nation's economic activity remains highly dependent on external forces. Mexico still rises and falls with the U.S. Rumors of decoupling, it seems, have been greatly exaggerated.

*Skelton is a business economist in the Financial Industry Studies Department and Quintin is a senior economist and advisor in the Research Department at the Federal Reserve Bank of Dallas.*

## Notes

<sup>1</sup> See "Labor Markets in Turbulent Times: Some Evidence from Mexico," by Sangeeta Pratap and Erwan Quintin, Federal Reserve Bank of Dallas *Southwest Economy*, no. 5, 2008.

<sup>2</sup> See "Las Remesas Familiares en 2008," Banco de México, Jan. 27, 2009.

<sup>3</sup> The many steps taken by Mexico to reduce its financial exposure are discussed in detail in "Mexico's Financial Vulnerability: Then and Now," by José Joaquín López and Erwan Quintin, Federal Reserve Bank of Dallas *Economic Letter*, vol. 1, no. 6, June 2006.

<sup>4</sup> Generally, "toxic assets" refers to financial products that are difficult to value and almost impossible to sell. More specifically, in the recent financial system volatility, toxic assets in the U.S. have included subprime mortgage-backed securities, among other products.

<sup>5</sup> For more information about the evolution of Mexico's financial system, see "Financial Globalization: Manna or Menace? The Case of Mexican Banking," by Robert V. Bubl and Edward C. Skelton, Federal Reserve Bank of Dallas *Southwest Economy*, no. 1, 2002.

<sup>6</sup> The modernization of Mexico's banking system is discussed in more detail in "Mexico Emerges from 10-Year Credit Slump," by Robert V. Bubl and Edward C. Skelton, Federal Reserve Bank of Dallas *Southwest Economy*, no. 3, 2005.

<sup>7</sup> Output growth projections can be found, for instance, in the International Monetary Fund's *World Economic Outlook Update*, July 2009, available for download at [www.imf.org/external/pubs/ft/weo/2009/update/02/index.htm](http://www.imf.org/external/pubs/ft/weo/2009/update/02/index.htm).

<sup>8</sup> For a discussion of Mexico's fiscal difficulties, see "Raising Taxes in Mexico," by Erwan Quintin, Federal Reserve Bank of Dallas *Southwest Economy*, no. 1, 2001.

## Taking the Economy's Pulse at Midyear

With Texas facing hard times, four of the Dallas Fed's regional experts give an update on the state's economic performance in 2009, looking at the key areas of employment, manufacturing, housing and energy.

**A**t the start of 2009, Texas' economy had already sunk into recession. Employment had begun to decline. The nation's downturn and declining exports took a toll on manufacturing. Housing prices were falling. The energy sector sagged due to falling oil and gas prices.<sup>1</sup>

We've now passed the year's midpoint—with the state still searching for an end to the recession. However, Dallas Fed economists see some signs of hope that the downturn may end sometime in the second half of 2009.

Here's a review that focuses on employment and three key sectors.



**Keith R. Phillips:**  
*Employment*

**Q. So far this year, what trends are you seeing in employment?**

**A.** Texas non-farm employment peaked in October 2008 and has declined sharply since then. During the second quarter of this year, the number of jobs fell at an annual pace of 2.7 percent, milder than the 5.2 percent decline in the first quarter.

**Q. Are any signs of recovery starting to emerge?**

**A.** While broad measures of economic activity continue to decline, leading indicators have improved recently. The Texas Leading Index rose in the second quarter following 11 consecutive months of decline. The three-month gain was particularly broad-based, with six of the eight indicators showing positive movements.

Our surveys of business leaders tell a similar story. The Dallas Fed's Beige Book, an anecdotal survey of business conditions, noted in July that demand was beginning to stabilize, and the respondents to the July Dallas Fed manufacturing survey expressed op-

timism that their business outlook would be positive by the end of 2009.

**Q. What's the employment outlook for the rest of the year and into 2010?**

**A.** In *Southwest Economy's* first-quarter issue, I forecasted that in 2009 Texas employment would decline by 2.8 percent, or 296,000 jobs. During the first seven months of this year, jobs fell by approximately 186,000. The current forecast suggests employment will bottom out during the current quarter and then begin a gradual increase.

Overall, the forecast is slightly stronger than the beginning-of-year one, suggesting a decline of about 2 percent, or 212,000 jobs.

I'm hesitant to forecast 2010 so far in advance since many things can change between now and the end of the year. But the current momentum in the economy and recent changes in the Texas Leading Index suggest a mild rebound in job growth next year to about 1 percent to 1.5 percent. The 30-year average for Texas job growth is 2.8 percent.



**Laila Assanie:**  
*Manufacturing*

**Q. What has been happening in the manufacturing sector?**

**A.** Early in 2008, slumping demand for products related to construction and autos curtailed Texas manufacturing output. Factory jobs fell by 14,000 in the first three quarters of the year. Since then, the state's factories have seen production decline further as domestic demand diminished more broadly and overseas sales plunged. Between October 2008 and June 2009, statewide factory payrolls shrank by another 74,800 jobs, or 10.7 percent.

The Texas Manufacturing Outlook Sur-

vey—the Dallas Fed's monthly survey of industry trends—reflected the industry's deterioration with accelerating contraction in the last quarter of 2008 and first two months of this year.

Recent readings haven't been as bad, suggesting that the decline in the state's factory activity has moderated over the past five months. In June and July, the Beige Book also reported signs of stabilization in the state's manufacturing. Some firms were even seeing a pickup in new orders as well as revived export demand.

**Q. Do you have some specifics?**

**A.** All the manufacturing survey's indexes of current activity have come off their record lows. But there's no real pickup in activity. In July, about half the respondents said growth in new orders was flat and 43 percent said production and shipments were little changed from the previous month.

In the July Beige Book, petrochemical producers reported a rise in export demand. High-tech firms said production had increased.

The pace of layoffs has tempered as well. Two-thirds of executives responding to the manufacturing survey noted stable staffing, and a nearly equal share reported no change in work hours. In a similar vein, the July Beige Book reported that most manufacturers were no longer downsizing operations because they'd already "right sized" their staff levels.

**Q. What does the industry expect for the rest of the year and into 2010?**

**A.** Although factory output and employment are still contracting, the worst seems to be behind us. The manufacturing survey's readings on expectations six months ahead have turned positive. Indexes for future production, capacity utilization, new orders and growth rate of orders have been improving since hitting record lows in November 2008, suggesting manufacturers expect business to firm up by the end of 2009 or early 2010.

In the July survey, more than 36 percent of producers noted that they expected

*“Current readings suggest a mild rebound in job growth next year to about 1 percent to 1.5 percent. The 30-year average for Texas job growth is 2.8 percent.”*

increases in production, capacity utilization and new orders six months from now. Moreover, the future company outlook index was positive for the second consecutive month, and 30 percent of manufacturing executives foresee improvement in their firm's outlook six months from now.



**D'Ann Petersen:**  
*Housing*

**Q. What are the recent trends in housing?**

**A.** While the downturn in home sales and construction began several years ago, conditions worsened in late 2008 as economic and financial issues became more pressing and homebuyers moved purchasing a home to the bottom of their to do lists. In 2009, the downward trend in sales and construction continued although at a slower pace.

During the downturn, home values held up much better in Texas than in other parts of the country. The Federal Housing Finance Agency's purchase-only price index shows Texas prices shrank less than 1 percent over the past year, compared with declines of more than 20 percent in Florida, California, Arizona and Nevada. Texas homes remain affordable compared with the national average.

**Q. Do you see any hopeful signs for housing?**

**A.** Texas housing shows some signs that the worst may be over. Homebuilders and Realtors reported homebuyer traffic picked up in the first half of the year, thanks to low mortgage interest rates and lower housing prices. Both sales and construction appear to be bottoming out in the second quarter.

New home construction remains at very low levels, but permits rose 14 percent and contract values increased 22 percent in the second quarter. At the same time, existing home sales were up almost 5 percent from the first quarter. Most of the activity has been in the lower-priced entry-level market as first-time homebuyers take advantage of the

\$8,000 tax credit available until Dec. 1 (see “Noteworthy,” page 14).

**Q. What's the outlook for the rest of the year and into 2010?**

**A.** It's uncertain whether the recent pickup in sales will continue after the expiration of the tax credit. Housing industry executives are more optimistic in their outlooks, but they're not quite sure whether a turnaround has begun or conditions have just bottomed out. For now, those in the industry appear thankful housing markets are no longer deteriorating.

The good news is that inventories aren't too out of line—especially compared with other areas of the country—partly because builders have pulled back strongly on new construction. When the Texas economy emerges from recession and job growth picks up, a rebound in home sales should lead to higher levels of homebuilding activity.



**Mine Yücel:**  
*Energy*

**Q. What are you seeing in the oil and gas markets?**

**A.** Weak demand continues to plague both markets. The global recession has led to a tremendous contraction in oil demand, with the greatest declines in Europe, Japan and the U.S. On the supply side, OPEC continues to rein in output, albeit with limited success. As a result, oil prices are less than half what they were a year ago. Since the beginning of the year, oil prices have come up off their low points, nearly doubling to around \$65 per barrel.

The demand for gasoline usually picks up in the summer driving season between Memorial Day and Labor Day. This summer, however, is shaping up to be quite feeble, with gasoline consumption lower than a year ago. Soft demand for gasoline is leading to low refinery capacity utilization, which fell to 84 percent at the end of July.

On the natural gas side, weak demand and plentiful supply have bloated inventories

to seasonal records and depressed prices to less than \$4 per million Btu, down from more than \$9 a year ago.

**Q: How has all this affected Texas?**

**A.** The weaker prices have curtailed the region's energy activity. The Texas rig count was 347 in July, about a third of what it was a year earlier. The Texas oil and gas industry lost 24,200 jobs in the first half of the year.

If there's a silver lining, it's the boost the domestic petrochemical industry is getting from the wide differential between oil and natural gas prices. At the beginning of August, crude was trading at an 18-1 ratio to natural gas, instead of the 6-1 ratio that would be warranted on a Btu basis. U.S. plants use natural gas as an input, while most foreign producers rely on crude oil. The cost advantage has spurred U.S. petrochemical exports.

**Q. Are any signs of recovery starting to emerge?**

**A.** Given the recent strengthening of oil prices, the rig count has started to inch back up, with most new drilling directed at oil. However, most indicators of energy demand remain depressed.

**Q. What's the outlook for the rest of the year and into 2010?**

**A.** As the U.S. and global economies improve, we should see both oil and natural gas prices firm up and energy activity strengthen. If crude stays above \$70–\$80 a barrel, it should bring increased investment into the oil sector. A recovering economy may not boost natural gas prices as much because supply is ample and inventories are near record highs.

Recovering demand for oil products will help refinery capacity utilization and producers' margins. The prospect of new environmental regulations creates some uncertainty. Whatever the shape of these new regulations, they'll likely increase costs for refiners and lower consumer demand.

**Note**

<sup>1</sup> See “Recession Arrives in Texas: A Rougher Ride in 2009,” by Keith R. Phillips and Jesus Cañas, Federal Reserve Bank of Dallas *Southwest Economy*, First Quarter 2009.

# Rising Protectionist Threat Creates Risks for Texas

By Edward C. Skelton and Mike Nicholson

*Expanding trade has brought jobs and business to Texas but has left the state particularly vulnerable to antitrade actions.*

Nobel Prize-winning economist Paul Krugman once wrote: “If there were an Economists’ Creed, it would surely contain the affirmations ‘I understand the Principle of Comparative Advantage’ and ‘I advocate Free Trade.’”<sup>1</sup>

Economists endorse free trade because it creates healthier, more prosperous and more dynamic economies. Protectionism can sometimes provide fleeting benefits to specific domestic industries, but in the medium and long run it causes economic stagnation and inefficiency.

Unfortunately, political expedience often leads countries to ignore well-established wisdom and enact protectionist policies to preserve jobs during economic slowdowns. Even relatively minor flirtations with protectionism can snowball, leading to trade skirmishes and perhaps all-out trade wars and negative feedback cycles between recession and protectionism.

Today’s financial turbulence has already brought restrictions on the flow of investment and capital.<sup>2</sup> Making matters worse, the surge in financial protectionism seems to be spreading to trade in goods and services. Yielding to protectionist pressures would increase prices and hurt industries that rely on foreign trade, worsening the recession in the short and medium run while hurting U.S. competitiveness in the long run.

Texas’ long border with Mexico, busy ports and industrial mix—as well as passage of the North American Free Trade Agreement (NAFTA) in 1994—have fostered a sizable flow of goods and services to and from foreign countries. Expanding trade has brought jobs and business to Texas but has left the state particularly vulnerable to antitrade actions. Texas would suffer greatly if the U.S. and other countries implement protectionist measures.

## The Import of Exports

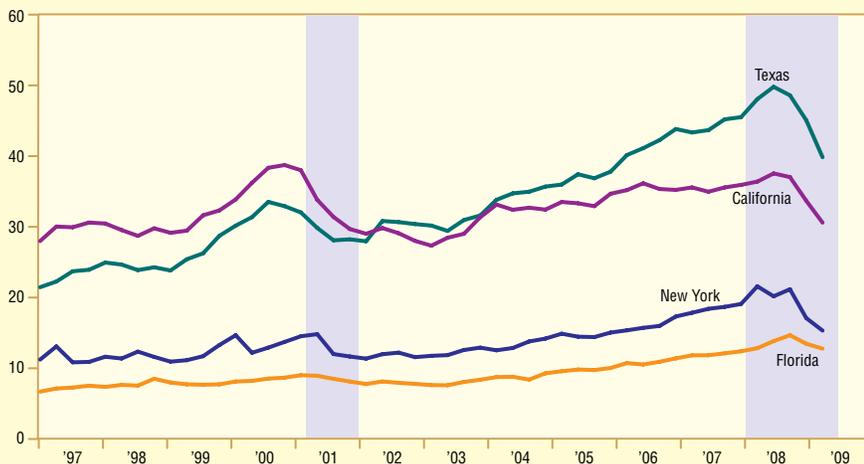
Texas benefits from trade. Data on the value of goods shipped overseas show that Texas has been the nation’s largest exporting state since 2002, beating even such East and West Coast giants as California, New York and Florida (*Chart 1*).<sup>3</sup> Texas accounts for about 15 percent of all U.S. exports.<sup>4</sup>

In 2008, exports made up 16.8 percent of state output, ranking Texas third among states, behind only Louisiana and Washington. Looking at states similar in size, exports’ share of state GDP was 7.6 percent in California, 7.3 percent in Florida and 6.7 percent in New York, placing the three in the bottom half of all states.

The Commerce Department’s most recent data show that 6.7 percent of Texas’ private-sector jobs were tied directly to goods exported in 2006, placing Texas 10th among states. Furthermore, the department reports that 22.9 percent of the state’s manufacturing jobs were linked to exports. Chemicals, computers and electronics, machinery and petroleum-related products

**Chart 1**  
**Texas Leads All States in Exports**

Billions of 2008 dollars



NOTE: Shaded areas represent U.S. recessions.

SOURCE: WISERTrade; seasonal and other adjustments by the Dallas Fed.

**Table 1**  
**Tracking Texas' Leading**  
**Exports in 2008**

Industry	Value (billions of 2008 dollars)	Share of Texas exports (percent)
Chemicals	38.2	19.9
Computers and electronics	35.4	18.5
Machinery	27.1	14.1
Petroleum and coal products	25.2	13.1
Transportation equipment	16.8	8.8
Primary metals	6.7	3.5
Electrical equipment, appliances	6.5	3.4
Agriculture	6.4	3.3
Fabricated metal products	6.0	3.1
Food	4.4	2.3

SOURCE: WISERTrade; seasonal and other adjustments by the Dallas Fed.

ranked as the top exporting industries in 2008 (Table 1).

Europe and Asia are growing markets for Texas exports, but the state's ties to Latin America run particularly deep. In 2008, the region provided a market for 46 percent of Texas' exports, representing 7.7 percent of the state's GDP. In contrast, U.S. exports to Latin America made up only 2 percent of GDP.

The growth of Texas' exports to Latin America has been aided by market-opening pacts such as NAFTA. About 70 percent of Texas' Latin America-bound exports go to Mexico. However, the state has diversified its trade in recent years. Exports to Brazil, Chile, Peru and Venezuela have all more than doubled in real terms since 2004, while sales to Mexico have declined.<sup>5</sup>

Research shows that free-trade agreements have boosted Texas' exports, GDP and employment. A Dallas Fed study found that NAFTA had a robust effect on Texas exports to Mexico, accounting for roughly a quarter of Texas' 111 percent increase in goods shipped to Mexico between 1993 and 2000.<sup>6</sup>

The study also found that NAFTA fostered statistically significant export gains to Mexico across a number of Texas' largest export sectors, including petroleum and coal products at 69 percent and electronic equipment at 49 percent.

A similar St. Louis Fed study used state-level data from 1988 to 1997 to show that NAFTA increased Texas' real exports to Mexico by an annual rate of 14 percent.<sup>7</sup>

The study found that NAFTA also had a statistically significant, positive impact on Texas' exports to the rest of Latin America.

Other free trade agreements are also fueling Texas' Latin American exports. Texas A&M researchers found that the agricultural provisions of the Central America Free Trade Agreement–Dominican Republic resulted in \$184.7 million of added business activity and 2,415 additional jobs for Texas.<sup>8</sup> Texas' exports to Chile have increased by 133 percent since the implementation of the U.S.–Chile Free Trade Agreement in 2004.

On net, the data suggest Texas' economy benefited from freer trade with Latin America. Even so, liberalization isn't without its downside.

All else being equal, both economic theory and empirical evidence suggest Texas workers in import-sensitive industries may lose jobs or experience wage cuts as a result of greater foreign competition. Workers displaced by trade face significant transition costs as they develop the job skills demanded by firms in other industries. During difficult economic times, these costs may rise, increasing the cries to protect unskilled domestic workers.

### Protectionist Rumbings

Despite the theoretical and empirical arguments in its favor, trade liberalization has been facing headwinds.

U.S. Trade Promotion Authority for approving trade agreements, also known as fast-track negotiating authority, was allowed to expire in 2007. Under fast track, Congress was barred from amending or filibustering trade agreements, making negotiations easier. Since then, Congress has exhibited a greater skepticism toward trade by failing to ratify free trade agreements with South Korea, Colombia and Panama.

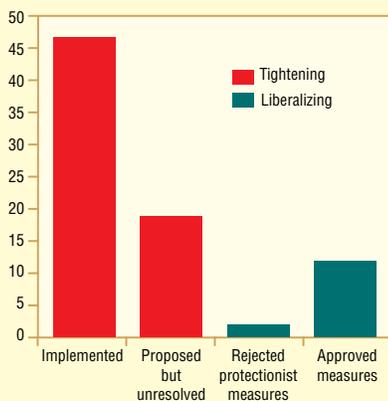
After years of stop-and-go talks, World Trade Organization negotiations broke down again in July 2008. These talks, formally known as the Doha Development Round, are aimed at lowering trade barriers and increasing global trade. Negotiations aren't expected to resume until later in 2009.

Protectionism often exacerbates economic downturns. Recognizing the danger in the current recession, the G-20 leaders signed a pledge in November 2008 to avoid protectionist measures. However, at least 17 of the countries reneged. Worldwide, 47 trade-restricting measures have been imple-

*Protectionism often exacerbates economic downturns. Recognizing the danger in the current recession, the G-20 leaders signed a pledge in November 2008 to avoid protectionist measures.*

**Chart 2**  
**Protectionism on the Rise**  
**in G-20 Countries**

(Trade policies proposed, October 2008 to February 2009)



NOTE: Excludes antidumping cases.  
 SOURCE: World Bank.

*Any significant trade restrictions imposed on imports from the U.S. could hurt Texas' exports. When faced with increased trade barriers, firms often cut workers, hours and wages or even move operations overseas.*

mented between October 2008 and February 2009 (Chart 2).

The U.S. included a Buy American provision in the recently enacted stimulus package, contradicting the G-20 commitment not to implement new protectionist measures.<sup>9</sup> Although it passed in a watered-down version stipulating that trade agreements trump the Buy American requirement, this provision provoked a great deal of international outrage.

The Buy American brouhaha turned out to be more symbolism than substance. A more significant trade skirmish broke out between Mexico and the U.S. in March 2009, touched off by a provision in the 2009 U.S. federal budget. The U.S. closed its southern border to Mexican long-haul trucks by ending a 2007 pilot program that allowed a limited number of Mexican carriers into the U.S. and U.S. carriers into Mexico.

The U.S. action appears to go against NAFTA. Under the pact, all Mexican carriers were authorized to deliver cargo to border states starting in 1995 and anywhere in the U.S. starting in 2000. In 1995, however, the opening to Mexican trucks was delayed, ostensibly due to safety concerns.<sup>10</sup>

The argument that Mexican trucks don't adhere to U.S. safety standards appears groundless. According to U.S. Department of Transportation data on random safety inspections, U.S. carriers had a noncompliance rate of 21.7 percent, compared with 20.7 percent for all Mexican carriers and 7.3 percent for the carriers in the pilot program.

Immediately following the truck ban, Mexico passed retaliatory tariffs of 10 to 45 percent on 89 U.S. products, whose cross-border sales are worth \$2.4 billion a year. The tariffs targeted states represented by U.S. lawmakers who supported the truck ban while sparing imports whose restriction would create hardships for the poorest Mexican households. To put additional pressure on the U.S., Mexican trucking companies have filed a suit accusing the U.S. of violating NAFTA.

Leaders elsewhere in Latin America are feeling pressure to shield their economies as trade drops, employment falls and populism gains traction. For example, Ecuador has sharply increased overall tariffs on more than 600 items, and Argentina has imposed new restrictions on many imports.

**Trade Vulnerabilities**

Latin America looms large for the three industries that generate more than half of Texas' exports. In 2008, 43 percent of computers

and electronic exports, 38 percent of chemical exports and 31 percent of machinery exports were bound for Texas' top 10 Latin American trading partners.<sup>11</sup> The new trade restrictions in Ecuador and Argentina target the machinery industry.

Historically, the food and apparel sectors have been hotbeds of protectionist sentiment. Approximately 57 percent of Texas' apparel exports and 55 percent of its food exports are bound for the state's top Latin American trade partners. Argentina and Ecuador have placed restrictions on apparel, while food figures prominently in Mexico's new package of tariffs.

Any significant trade restrictions imposed on imports from the U.S. could hurt Texas' exports. When faced with increased trade barriers, firms often cut workers, hours and wages or even move operations overseas.

We don't know how many jobs will be lost due to any particular protectionist measure. However, employment data do give us some idea of how many jobs might be at risk. The three largest exporting sectors ranked by dollar value employed 3.2 percent of the state's private sector workforce as of December 2008 and composed 6.7 percent of its GDP in 2007, the last year for which data are available. The food and apparel sectors account for 1 percent of Texas' GDP and a little less than 1 percent of the state's employment.

All told, widespread protectionism threatens workers and could be expensive

**Table 2**  
**Some Latin American Countries Depend Heavily on Exports**

Country	Exports to the U.S. (percent of GDP)
<b>Mexico</b>	<b>18.2</b>
Ecuador	16.5
Venezuela	15.0
<b>Costa Rica</b>	<b>12.8</b>
<b>El Salvador</b>	<b>9.5</b>
<b>Guatemala</b>	<b>7.8</b>
Colombia	5.2
<b>Chile</b>	<b>4.6</b>
<b>Peru</b>	<b>4.4</b>
Brazil	1.8
Argentina	1.7

NOTE: Bold indicates countries with free trade agreements with the U.S.  
 SOURCE: International Monetary Fund.

to the state in terms of forgone business activity. The toll would rise if a cycle of protectionist retaliation spreads the ill effects of trade barriers to other Texas industries.<sup>12</sup>

Latin American countries also have a lot to lose from protectionism. Their economies rely heavily on exports, primarily goods and raw materials bound for the U.S.

In 2008, exports across its northern border made up 18 percent of GDP in Mexico, Texas' biggest trade partner.<sup>13</sup> Exports are an important share of GDP for other top Texas trading partners, notably Venezuela, Colombia and Chile (Table 2).

Free trade agreements have had a positive effect on some Latin American economies. Mexico's exports have grown substantially since NAFTA's implementation in 1994 (Chart 3A). Despite the country's attempts to diversify its exports, nearly three-quarters of overseas sales still went to the U.S. in 2008. Chile depends less on the U.S. market; even so, its exports surged following implementation of the Chile-U.S. free trade agreement in 2004 (Chart 3B). Free trade agreements with Central America and Peru are still too new to gauge their effects.

For most countries, increasing overseas

sales go hand-in-hand with rising foreign direct investment (FDI), particularly in exporting sectors. FDI is important because it encourages economic development and accelerates the transfer of technology to developing countries, making their economies more competitive.

For many Latin American countries, exports to the U.S. constitute a substantial proportion of their overall GDP, and the detrimental effects of protectionism could be significant. If declining exports make countries less competitive, this could trigger decreases in FDI in the longer run. This might also damage an important source of financial stability in a time when international financial turbulence has taken a significant toll on regional economies.

### 'Crack Cocaine of Economics'

Economists overwhelmingly support trade liberalization because of its most powerful implication—that countries can capitalize on their comparative advantages, lowering consumer prices and boosting world GDP in the long run. Despite economists' blessing, freer trade nearly always faces political pressures favoring beggar-thy-neighbor policies intended to protect some domestic workers and businesses. The specter of protectionism tends to loom when economies falter and anxieties over jobs and incomes build.

In a C-SPAN interview in February 2009, Dallas Fed President Richard W. Fisher remarked, "Protectionism is the crack cocaine of economics. It may provide a high. It's addictive, and it leads to economic death."

Fisher's words carry a warning for Texas, a state that has enjoyed significant benefits from foreign trade. This very success leaves the state exposed to protectionist experimentation, particularly in the Americas. While attempts to curtail imports and lock out foreign companies damage the U.S. economy and harm U.S. consumers, the effects would be particularly detrimental to the Texas economy.

*Skelton is a business economist in the Financial Industry Studies Department and Nicholson is an analyst in the Research Department of the Federal Reserve Bank of Dallas.*

### Notes

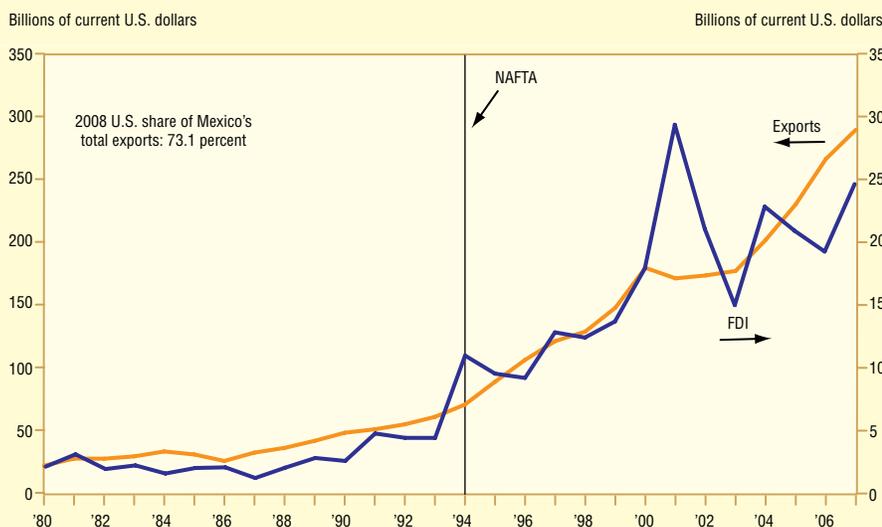
<sup>1</sup>"Is Free Trade Passé?" by Paul R. Krugman, *Journal of Economic Perspectives*, vol. 1, no. 2, 1987, pp. 131-44.

<sup>2</sup> See "Global FDI Policy: Correcting a Protectionist Drift," by David M. Marchick and Matthew J. Slaughter, Council on

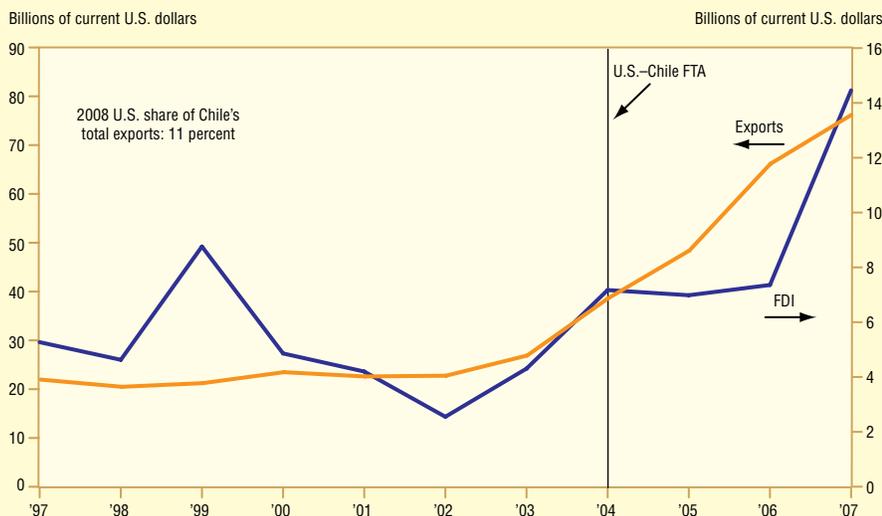
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**Chart 3**  
**Exports Increase After Free Trade Agreements**

#### A. Mexico: Global Exports and FDI Inflows



#### B. Chile: Global Exports and FDI Inflows



NOTE: Exports calculated on a balance-of-payments basis.

SOURCE: World Bank Development Indicators.

**QUOTABLE:** *“The downward slide in the Texas economy continues to slow. Recent indicators and anecdotal reports continue to point toward stabilization, albeit at subdued levels.”*

D’Ann Petersen, Business Economist



## TEXAS AGRICULTURE: Drought Damages Mount for Farmers, Ranchers

A drought that’s persisted for two years shows no signs of relenting, taking an increasing toll on Texas agriculture. Since November 2008, producers have lost an estimated \$2.6 billion in crops and \$974 million in livestock. Texas A&M’s AgriLife Extension Service projects that drought losses could exceed \$4.1 billion by the end of the year.

Although most of the state has been affected, conditions in Central and South Texas are particularly dire. Most dryland crops in those areas are expected to reach only a small fraction of normal yields, and many farmers could face total losses.

Cotton, sorghum, wheat and corn have taken the hardest hits. According to the U.S. Department of Agriculture,

a third of Texas cotton acreage is in poor condition. Texas A&M’s Mark Welch estimates yields will be down 69 percent for sorghum, 62 percent for wheat and 45 percent for corn. As a result, many farmers have abandoned acreage and collected insurance payments.

The drought has also hurt Texas ranchers. Many lakes and stock ponds are depleted or dried up, leaving pastures across the state in poor condition. Some regions are facing hay shortages. The depleted supplies of water and feed are forcing many ranchers to sell cattle herds at a loss. Horse ranchers, sheep and goat farmers, and beekeepers also face substantial losses.

—Mike Nicholson



## VENTURE CAPITAL: U.S. Rises, but Texas Continues Its Decline

Texas found itself left out of the nation’s first quarterly uptick in venture capital activity since 2007. Investment in the state fell 58 percent from the first to second quarter, coming in at \$74 million, its lowest level since data first became available in 1995.

The dismal reading comes on the heels of a weak first quarter. Texas venture capital investment is now 77 percent below where it was at the end of 2008.

Texas had enjoyed a steady 5 percent share of U.S. venture capital over the past several years, ranking behind only California’s 48 percent and Massachusetts’ 12 percent. For the second quarter, however, Texas dropped to 12th as Colorado, New York, Pennsylvania and other states re-

ceived more of the nation’s venture capital funding.

The latest report from PricewaterhouseCoopers and the National Venture Capital Association also shows that Texas experienced shifts across industries.

The share of venture capital going to the industrial and energy sector fell from 42 percent in the first quarter to less than 10 percent in the second quarter. Contracting energy-related activity due to low oil and gas prices likely contributed to the decline.

Networking and equipment sector funding was up 25 percent. Allocations also rose for consumer products and services and computers and peripherals.

—Emily Kerr



## HOUSING: Tax Credit Boosts Sales to First-Time Buyers in Texas

The beleaguered Texas housing market has been getting some help from Washington’s attempts to revive the economy. First-time homebuyers in the state are taking advantage of tax credits of as much as \$8,000 provided by the American Recovery and Reinvestment Act of 2009.

Due in part to the credit, first-time buyers account for almost half of U.S. home sales this year, the National Association of Realtors reports. The Beige Book, the Dallas Fed’s anecdotal survey of regional business activity, suggests the percentage may be even higher in Texas, with contacts saying tax credits have been a factor in as much as 80 percent of sales at some companies.

Texas existing home sales increased 0.8 percent in

the second quarter, rebounding from more than two years of declines and a near-record 10.8 percent contraction in fourth quarter 2008—just before the tax credit took effect Jan. 1. Existing home inventories have since leveled off, and the median home price has rebounded 6.1 percent from its November 2008 low.

The challenge will be maintaining this momentum in the face of high unemployment, low appraisal values and the tax credit’s Dec. 1 expiration date. Another key issue is whether households took advantage of the tax credits to buy this year rather than next—and how much that will dampen the housing market in 2010.

—Jessica Renier

Texas became the nation's most prolific generator of wind power in the past decade, but the industry's future growth will depend on tax incentives to make it cost competitive and new transmission lines to get electricity to consumers.

With advances in turbine technology and tax breaks, wind power is now the largest source of renewable energy generation in Texas and second only to hydroelectric in the nation. The state's installed capacity is approaching 8,500 megawatts (MW)—just over 28 percent of the U.S. total, up from 7 percent a decade ago (*Chart 1*).

If projects under construction in Texas are completed by year's end, capacity will increase by nearly 30 percent in 2009. While significantly below last year's 65 percent gain, this growth rate just about matches the median of 37 percent over the past nine years.

On a generation-cost basis, wind energy is competitive with conventional forms of power—but only after taking tax incentives into account (*Chart 2*). The American Recovery and Reinvestment Act of 2009 extended the federal production tax credit

(PTC) through the end of 2012. It provides renewable energy facilities a 2.1 cent per kilowatt hour credit for the first 10 years of operation. Texas offers additional incentives for developing renewable energy—for example, exemption from property taxes.

Tax incentives appear critical in driving wind industry growth. Every time Congress has allowed the PTC to expire, new installed capacity dropped significantly the next year. When the PTC lapsed in 2001, Texas saw no new capacity in 2002 and U.S. capacity grew only 10 percent, down from 66 percent the previous year. In 2003, the PTC lapsed again, and Texas saw another year of no new capacity in 2004.

### Distance Poses Obstacle

Connecting new capacity to the grid is one of Texas' greatest challenges. Hills surrounded by open plains are the best locations for wind power, so most turbines are in Texas' west and northwest regions, far from consumers in urban areas.

Transmission lines from west and north-west Texas require an estimated investment

of \$1.5 million per mile. Earlier this year, the Public Utility Commission of Texas began awarding contracts to build 18,456 MW of transmission capacity under a \$4.93 billion project funded by fees on residential customers' electricity bills.

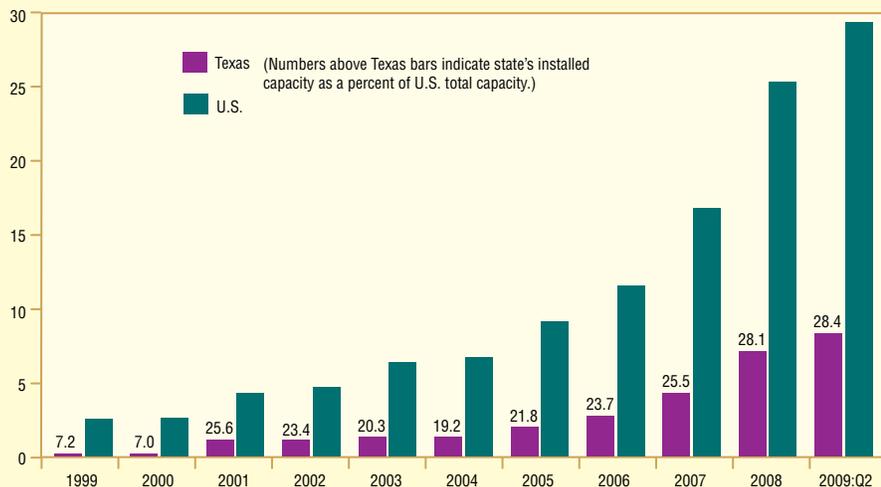
Continued growth in wind power benefits Texas' economy. The National Renewable Energy Laboratory estimates that each 100 MW of installed capacity creates six to 10 permanent operation and maintenance jobs. The construction process supports 100 to 200 temporary jobs. In addition, landowners and farmers who allow wind turbines to be located on their property receive rental payments.

Difficulties raising capital in the aftermath of a credit crisis and low natural gas prices will likely slow capacity growth in the short term, but Texas' geography provides an edge in wind power. Wind energy now makes up only 3.5 percent of Texas electricity consumption, but it's likely to continue growing over the longer term, becoming a viable energy source for the state.

—Jackson Thies

**Chart 1**  
**Wind Power Capacity Rises in U.S., Texas**

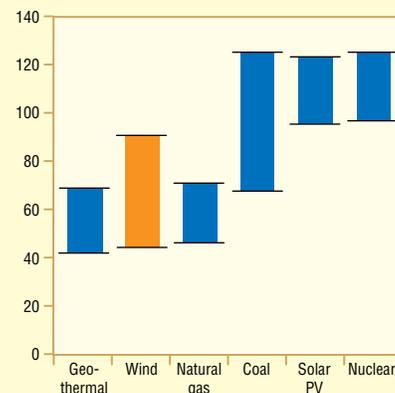
Megawatt installed capacity (thousands)



SOURCES: "2nd Quarter 2009 Market Report," American Wind Energy Association; Texas Comptroller of Public Accounts.

**Chart 2**  
**Wind Power Competitive—With Incentives**

Dollars per megawatt hour



NOTE: Price ranges reflect all applicable tax incentives and capital costs. Assumes coal price of \$1.75 per million Btu and natural gas price of \$4 per million Btu.

SOURCES: Lazard: Levelized Cost of Energy Analysis—Version 2.0; other calculations by the Dallas Fed.

# Restoring Banking's Safety Net: Deposit Insurance's Steeper Cost

By Kory Killgo

*Premiums will rise for banks in the Dallas-based Eleventh Federal Reserve District—but not by as much as they will for banks in the rest of the country.*

Deposit insurance has been a fundamental part of the U.S. banking system since the newly chartered Federal Deposit Insurance Corp. (FDIC) opened on Jan. 1, 1934. Over the next 75 years, the FDIC has protected millions of depositors and helped thousands of institutions weather economic storms—without the loss of any insured deposits.

Banks pay premiums to insure their deposits. Institutions with more deposits or weaker conditions pay more—much like the cost of automobile insurance depends on the value of the car and the driving record of the person behind the wheel. Insured banks contribute each quarter to the Deposit Insurance Fund (DIF), which the FDIC uses to cover the expenses related to resolving failed banks.

For banks, the premiums are an ongoing expense, a recurring reduction in earnings and profitability. However, deposit insurance's protection is a key factor in institutions' ability to attract and retain deposits. A stable deposit base insulates banks

from the kind of runs that marked the early years of the Great Depression, allowing the institutions to function more efficiently as financial intermediaries. In turn, greater efficiency in the financial system promotes a more efficient and robust economy.

A recession now in its 21st month has presented tremendous challenges to the deposit insurance system. Actual and expected bank failures have left the DIF below its mandated level; the fund's balance declined from \$45.2 billion on June 30, 2008, to \$10.4 billion on June 30, 2009.

The FDIC has responded by raising the premiums banks pay. Premiums will rise for banks in the Dallas-based Eleventh Federal Reserve District—but not by as much as they will for banks in the rest of the country.<sup>1</sup> This additional cost is an important consideration because every dollar spent on insurance is a dollar that can't be lent or otherwise invested.

## Replenishing the DIF

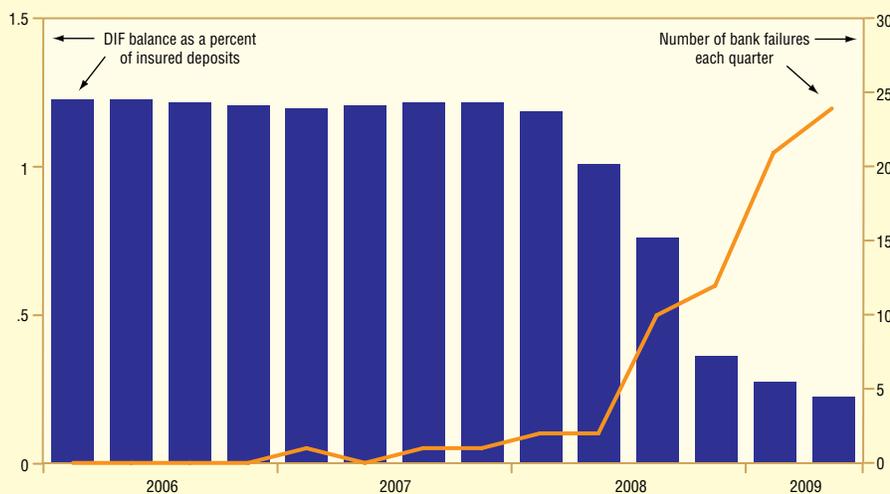
Twenty-five FDIC-insured institutions failed nationwide in 2008, and another 45 failures occurred in the first six months of 2009. This followed a decade with no more than 11 failures a year, including a 31-month period from mid-2004 to early 2007 with no failures.

The DIF reserve ratio—its balance as a percentage of estimated insured deposits—fell from 1.22 percent at the end of 2007 to 0.36 percent on Dec. 31, 2008, then slipped further to 0.22 percent on June 30, 2009 (Chart 1).<sup>2</sup>

When the reserve ratio fell below 1.15 percent in the second quarter of 2008, the law required the FDIC to return it to at least that level within five years. The current downturn's severity led the FDIC to grant an extension to seven years. Even with the added time, forecasts indicated that collecting premiums at rates then in effect wouldn't rebuild the DIF quickly enough to meet expected demands on the fund.

To ensure the DIF's stability and maintain public confidence, the FDIC implemented

**Chart 1**  
**Pressure Builds on the Deposit Insurance Fund**



SOURCE: Federal Deposit Insurance Corp.

three changes to the way insurance premiums are calculated. These adjustments are expressed in basis points, a banking industry measure equal to one 100th of a percentage point.

First, it imposed an annualized premium increase of 7 basis points in the first quarter of 2009—7 cents for every \$100 of assessable deposits.

Second, the FDIC adjusted the premium formulas to make the system more sensitive to insured institutions' financial conditions and the impact their failures could have on the DIF. The new approach considers more factors in calculating assessments and widens their range. Annualized premiums were 12 to 50 basis points in the first quarter of 2009. Starting in the second quarter, the premiums range from 7 to 77.5 basis points.

Third, the FDIC proposed a one-time premium of 20 basis points on applicable deposits at all institutions, regardless of condition, as of June 30, 2009. After further analysis and public comment, the FDIC modified its proposal, opting to calculate the one-time assessment as 5 basis points on adjusted assets.<sup>3</sup>

To bolster confidence in banks, Congress raised the insurance limit from \$100,000 to \$250,000 per depositor on individual accounts in October 2008. This year, Congress extended the extra coverage through the end of 2013. Higher assessments would likely have been needed with or without the new limits.

## The Cost to Banks

The FDIC believes these changes are critical to restoring the DIF to appropriate levels. But how will they impact banks, particularly smaller banks, which tend to fund more of their business with deposits? And how will the changes affect Eleventh District banks?

Addressing these questions begins with a baseline that looks at the premium assessment method in place for 2008 (*see box*). Then we compare it to the adjusted method used in the first quarter of 2009 (step 1) and to the revised method used beginning in the second quarter (step 2). Finally, we look at the impact of the special assessment.

Data for comparing the different calculation methods are collected in the quarterly Report of Condition and Income filed by financial institutions as of Dec. 31, 2008. Other inputs are institutions' safety and soundness ratings and, where available, their long-term

## Calculating the Assessment: A Primer

Risk categories determine the assessment rates banks pay for deposit insurance. The FDIC assigns all insured institutions to one of four risk categories based on two factors: regulatory capital and supervisory group.<sup>1</sup>

A bank's capital level determines whether it's well, adequately or undercapitalized.<sup>2</sup> The supervisory group reflects a bank's safety and soundness rating. The rating, assigned by bank examiners, ranges from 1 to 5, with a 1-rated institution the most sound.

In this table, supervisory group A includes most banks with safety and soundness ratings of 1 or 2. Most 3-rated banks are in group B, and most 4- or 5-rated banks are in group C.

Capital level	Supervisory group		
	A	B	C
Well capitalized	Category I	Category II	Category III
Adequately capitalized	Category II	Category II	Category III
Undercapitalized	Category III	Category III	Category IV

Under the baseline method in place on Dec. 31, 2008, assessment rates for banks in category I, the safest, are set in a range based on additional analysis of their safety and soundness rating, plus their long-term debt rating (for banks with more than \$10 billion in assets that have such ratings) or condition ratios (for all other banks).<sup>3</sup>

Annualized assessment rates for the four risk categories calculated for Dec. 31 were:

Baseline method	Risk category			
	Category I	Category II	Category III	Category IV
Assessment rates (basis points)	5 to 7	10	28	43

With the March 31, 2009, assessment, the FDIC increased all categories by 7 basis points (step 1).

Step 1	Risk category			
	Category I	Category II	Category III	Category IV
Assessment rates (basis points)	12 to 14	17	35	50

The FDIC made extensive adjustments beginning with the June 30, 2009, assessment. The new model analyzes the condition ratios of all banks regardless of size. It adds special rate adjustments for levels of secured liabilities and brokered deposits, which can increase a bank's assessment rate, and unsecured debt, which can lower the rate.

The resulting approach (step 2) is more sensitive to the factors that the FDIC's research has shown to be important predictors of a bank's financial condition. The overall range of possible assessment rates has also expanded significantly.

Step 2	Risk category			
	Category I	Category II	Category III	Category IV
Assessment rates (basis points)	7 to 24	17 to 43	27 to 58	40 to 77.5

### NOTES:

<sup>1</sup> A thorough description of recent developments in the FDIC's premium assessment process is available at [www.fdic.gov/deposit/insurance/assessments/index.html](http://www.fdic.gov/deposit/insurance/assessments/index.html) and in the Federal Register, vol. 74, no. 41, March 4, 2009, pp. 9,525–63.

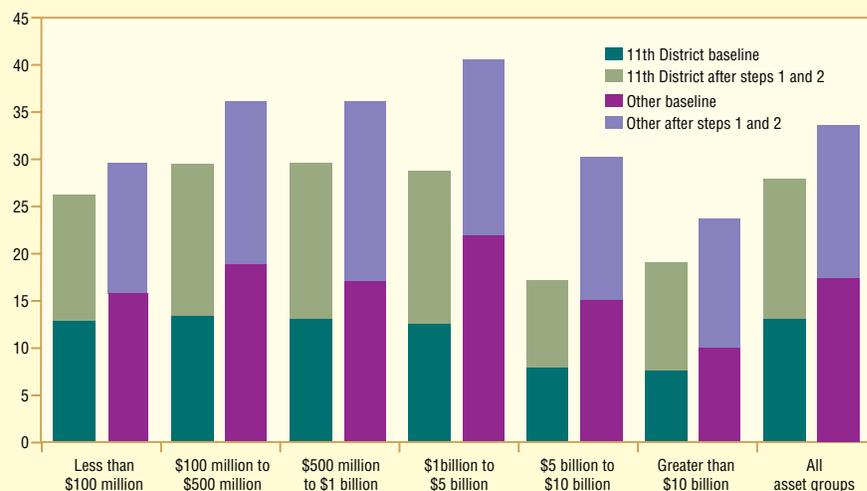
<sup>2</sup> A detailed definition is available in the Federal Reserve's Commercial Bank Examination Manual, Section 4133.1, updated November 2006; the manual is available online at [www.federalreserve.gov/boarddocs/supmanual/supervision\\_cchem.htm](http://www.federalreserve.gov/boarddocs/supmanual/supervision_cchem.htm).

<sup>3</sup> Ratios represent tier 1 leverage, loans past due 30–89 days, nonperforming assets, loans charged off, pretax net income and (under step 2) brokered deposits.

*The FDIC's actions put a noticeable dent in commercial banks' capital, defined broadly as total assets less total liabilities.*

**Chart 2**  
**FDIC Premiums Lower for Eleventh District Banks**

Assessments as a percent of capital, in basis points



SOURCES: Federal Deposit Insurance Corp.; Federal Reserve's National Examination Database; SNL Financial; author's calculations.

debt ratings.<sup>4</sup> These inputs are used to determine an institution's risk category, which in turn sets its premium level. This analysis omits some factors that affect the premiums banks actually pay, so the results only approximate the impact of the assessment changes implemented by the FDIC.<sup>5</sup>

The FDIC's actions directly address the need to restore the DIF. However, they put a noticeable dent in commercial banks' capital, defined broadly as total assets less total liabilities. Capital serves as a critical cushion that banks maintain to absorb losses.

For the commercial banking industry, the total assessment amounts to 0.17 percent of capital per calendar quarter under the baseline, 0.31 percent under step 1 and 0.33 percent under step 2. The assessments under all three methods, on average, constitute a smaller percentage of capital for banks headquartered in the Eleventh District than for institutions based elsewhere (*Chart 2*).

Grouping banks by size reveals additional details of the assessment system's impact. This approach divides banks into six groups based on assets: less than \$100 million, \$100 million to \$500 million, \$500 million to \$1 billion, \$1 billion to \$5 billion, \$5 billion to \$10 billion and over \$10 billion.

In general, banks in the two largest asset-size groups pay the least in assessments as a share of capital.

Outside the Eleventh District, banks with assets greater than \$10 billion have the

lowest average rates as a percent of capital under the baseline method and steps 1 and 2. Banks in the \$1 billion to \$5 billion group have the highest assessments.

Inside the Eleventh District, the lowest assessment rates relative to capital are in the \$5 billion to \$10 billion group. Rates are slightly higher in the largest asset group and noticeably higher in asset groups less than \$5 billion.

### The Special Assessment

Steps 1 and 2 represent the FDIC's response to deteriorating conditions in the industry. Projections indicated, however, that premiums collected from the new assessments wouldn't be enough to restore the DIF to mandated levels in the required time frame, leading the FDIC to propose a special assessment.

The original 20-basis-point proposal would have averaged 1.65 percent of commercial bank capital nationwide and 1.67 percent in the Eleventh District, but it triggered an outcry from smaller banks, concerned that sound community banks with high relative levels of deposits would bear an unfair burden.

For example, a well-capitalized bank paying the minimum premium under the current calculation method would pay almost three times as much in this single assessment as it would for a whole year's premiums.

The FDIC subsequently modified the

special assessment, calculating it as 5 basis points multiplied by adjusted assets instead of deposits.

The FDIC capped the dollar amount at 10 basis points times the bank's deposit assessment base. If the FDIC finds a need for further special assessments, it can levy similar 5-basis-point supplements at the end of September and December.

The special assessment as adopted equals approximately 0.46 percent of capital for all banks and 0.45 percent for district banks.

The revision significantly reduces funds collected for the DIF, but it imposes a lighter burden on banks, provided the FDIC doesn't implement the September and December assessments.

Basing the special assessment on assets instead of deposits also treats banks of different sizes more uniformly. In the Eleventh District, the original 20-basis-point plan would have resulted in a maximum difference in average assessment rates across size categories of 76 basis points. Under the adopted method, the range is 11 basis points.

### Why the Differences?

The observation that banks in the two largest size groups tend to have lower assessments than those in smaller groups is consistent with larger banks' relatively lower levels of deposits—which translates into lesser premiums in an assessment system based on deposits. This applies to banks

both in and out of the Eleventh District (*Chart 3*).

Eleventh District banks have higher relative levels of deposits, so we would expect their assessments to be higher than banks elsewhere—but that isn't the case. The reason involves the condition of the banks.

The FDIC places insured institutions in one of four risk categories. In the Eleventh District, a greater percentage of banks falls into the lowest risk category—a function of district banks' generally higher safety and soundness ratings and levels of capital. Ninety-three percent of Eleventh District banks are in the FDIC's lowest risk category, compared with 86 percent of banks elsewhere. Because of these factors, they tend to have lower assessments.

Overall, applying the scenarios to year-end 2008 data suggests a generally lighter impact in the Eleventh District than elsewhere. Expressed as a percent of capital, deposit insurance premiums for district banks were less than assessments for banks elsewhere in all asset groups and under the baseline, step 1 and step 2. The special assessment was similar or lighter for district banks.

The condition of Eleventh District banks offsets their relatively higher concentration of deposits, reducing assessments and freeing up capital.

*Killgo is a financial industry analyst in the Financial Industry Studies Department of the Federal Reserve Bank of Dallas.*

### Notes

<sup>1</sup> The Federal Reserve Bank of Dallas is the main office of the Eleventh Federal Reserve District, which comprises Texas, southern New Mexico and northern Louisiana.

<sup>2</sup> DIF data for 2009 are preliminary and unaudited.

<sup>3</sup> Adjusted assets are total assets, less tier 1 capital; tier 1 capital includes common stockholders' equity, qualifying perpetual preferred stock, certain minority interests and trust preferred securities.

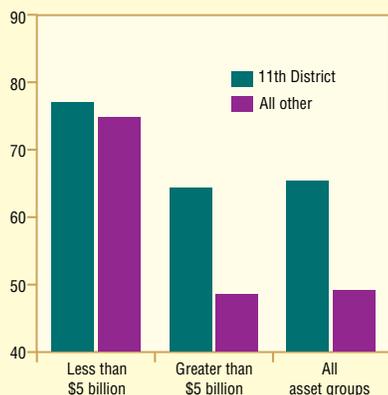
<sup>4</sup> Safety and soundness ratings are from the Federal Reserve's National Examination Database. Long-term debt ratings are from SNL Financial.

<sup>5</sup> Among factors not considered in this analysis are the effects of a one-time credit available to some banks, potential case-by-case adjustments made by the FDIC to the assessments of large banks, and an institution's possible migration between risk categories during the quarter.

*The observation that banks in the two largest size groups tend to have lower assessments is consistent with larger banks' relatively lower levels of deposits—which translates into lesser premiums in an assessment system based on deposits.*

**Chart 3**  
**Eleventh District Banks Depend More on Deposits**

Deposits as a percent of assets



SOURCES: Federal Deposit Insurance Corp.; Federal Reserve's National Examination Database; SNL Financial; author's calculations.

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## Rising Protectionist Threat Creates Risks for Texas

(Continued from page 13)

Foreign Relations, Council Special Report no. 34, June 2008.

<sup>3</sup> Imports also make important contributions to the economy. At a minimum, bringing in foreign products lowers prices and increases consumers' choice. Unfortunately, data that apportion U.S. imports among the states don't exist, leaving the analysis of trade's impact on Texas to focus solely on exports.

<sup>4</sup> It is important to note that these data, which come from the World Institute for Strategic Economic Research (WISER), are measured on an origin of movement basis, reflecting the state from which merchandise begins its movement to the final point of export. WISER adjusts Census Bureau data compiled from Shipper's Export Declarations (SED). Consequently, the available data have limitations. For instance, the SED occasionally indicates the state of brokers, wholesalers or freight consolidators rather than producers of the good bound for export. This bias is more pronounced for agricultural shipments than for manufactured exports. The Census Bureau is currently working to address this inconsistency.

<sup>5</sup> Texas has also successfully diversified by increasing trade beyond Latin America. For instance, since 2004, real exports to the European Union have grown at a rate of 50 percent, and real exports to China have grown at a rate of 40 percent.

<sup>6</sup> "Did NAFTA Spur Texas Exports?" by Anil Kumar, Federal Reserve Bank of Dallas *Southwest Economy*, no. 2, 2006.

<sup>7</sup> "NAFTA and the Changing Pattern of State Exports," by Cletus C. Coughlin and Howard J. Wall, *Papers in Regional Science*, vol. 82, no. 4, 2003, pp. 427–50.

<sup>8</sup> "Economic Impacts of CAFTA–DR on Texas," by Parr Rosson and Flynn Adcock, Center for North American Studies, Issue Brief 2007–09, Texas A&M University, December 5, 2007.

<sup>9</sup> This Buy American provision is Section 1605 of the

American Recovery and Reinvestment Act. It would have had little direct impact even in its original form. The additional U.S. steel production fostered by the provision would support roughly 1,000 jobs. See "Buy American: Bad for Jobs, Worse for Reputation," by Gary Clyde Hufbauer and Jeffrey J. Schott, Peterson Institute for International Economics, Policy Brief 09-2, February 2009.

<sup>10</sup> The prohibition on Mexican trucking in the U.S. is only applicable to new carriers attempting to transport goods from Mexico into the U.S. There are more than 800 Mexican carriers, all majority-owned by American firms that have trucking permits grandfathered from more than 20 years ago.

<sup>11</sup> The top 10 Latin American trading partners are Mexico, Brazil, Venezuela, Colombia, Chile, Peru, Argentina, Ecuador, Guatemala and Costa Rica.

<sup>12</sup> If no other country responds with trade barriers, it is true that unilateral protectionism can be beneficial in the short and medium run. However, research suggests that even unilaterally opening an economy to trade can be beneficial. See "Measuring the Benefits of Unilateral Trade Liberalization, Part I: Static Models" and "Measuring the Benefits of Unilateral Trade Liberalization Part 2: Dynamic Models," by Carlos Zarazaga, Federal Reserve Bank of Dallas *Economic and Financial Review*, Third Quarter 1999 and First Quarter 2000.

<sup>13</sup> Unlike with the other Latin American countries, much of Texas' exports to Mexico consist of intermediate goods. They're particularly important to Mexico's maquiladora industries, which process or assemble U.S. inputs for export back to the U.S.