the Southwest
ECONOMY

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Economic Outlook for the Southwest

The economy of the Southwest became more like that of the nation during the 1980s. (In this article, *Southwest* refers to Louisiana, New Mexico and Texas.) The region's economic performance last year reflected this similarity to the national economy, and will do so again in 1990. As growth of the national economy slows this year, so too will economic growth slow in the Southwest.

Employment in the Southwest rose by an estimated 1.8 percent in 1989 (Chart 1). This growth was quite close to that experienced at the national level. In 1990, employment growth in the Southwest is likely to be about 1.5 percent.

This year the Southwest economy will reflect the weaknesses of the national economy. Declining growth in manufacturing and the service-producing sectors of the economy will more than offset modest improvements in energy and construction. Agriculture will remain flat.

Chart 1
Employment Growth for the Southwest, 1985–90

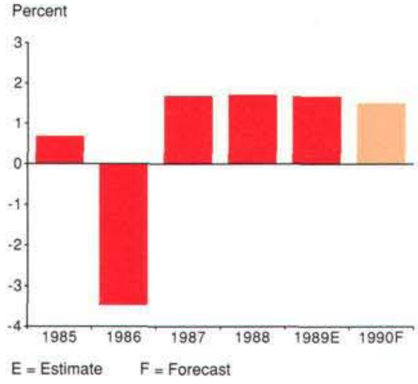
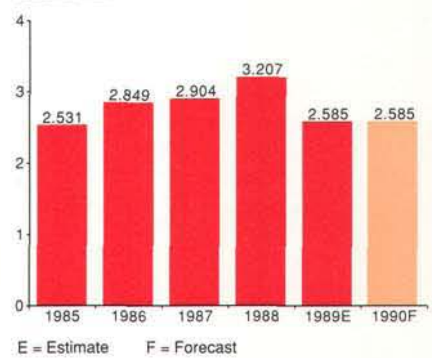


Chart 2
Net Cash Income for Texas Farmers, 1985–90



Effects of Freeze May Keep Agricultural Income Flat

Overall, farmers in the Southwest had a poor year in 1989. Drought and reduced cotton acreage decreased production. Higher prices held farm receipts stable, but increased expenditures and reduced government payments decreased net cash income by nearly 20 percent (Chart 2).

The severe freeze in South Texas aggravated the poor year. The freeze damaged or killed many unharvested vegetable crops. The nursery industry

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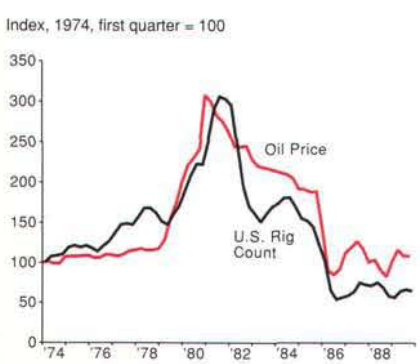
also reported losses. Damage to about half the citrus crop resulted in a production loss of about $50 million. Fruit trees sustained damage, which indicates substantial future losses. Reports already suggest that citrus trees may be unable to produce marketable fruit next season.

Largely as a result of the freeze, net cash income will likely remain at 1989 levels in 1990. Had there been no freeze, increased production of beef, cotton and most other crops, combined with somewhat lower prices, would have brought some gains in net farm receipts. Stable expenses and further reductions in government payments also would have contributed to a modest gain in net cash income.

Gas and Oil Price Increases Likely

The strength of the energy-extraction industry has traditionally depended on oil prices. As Chart 3 illustrates, however, this relationship became less evident in the past few years. Although the rig count increased throughout much of 1989, it is now about 10 percent lower than it was in early 1988 when oil prices were lower. As the United States depletes its oil resources, major oil companies are diverting their exploration and development efforts to oil overseas.

Chart 3
Inflation-Adjusted Oil Price and the U.S. Rig Count



As domestic drilling for oil declines, drilling for natural gas shows increases. Abundant resources and expectations of rising natural gas prices are stimulating domestic drilling for natural gas. Last summer, the natural gas rig count exceeded the oil rig count for the first time in history.

Despite sharply increased OPEC production, oil prices were fairly steady in 1989. The price of West Texas Intermediate crude oil ranged from $18 to $21 per barrel, and the annual average price exceeded the 1988 average by more than 20 percent. Prices were higher and more stable in 1989 because world oil demand increased sharply and non-OPEC production declined. Given forecasts of continued growth in world oil demand and a new OPEC accord, oil prices are likely to be slightly higher in 1990.

Natural gas prices are also likely to be higher this year. And, with the gradual demise of the gas bubble, natural gas prices are likely to rise more rapidly than oil prices over the next few years. (*Gas bubble* refers to the natural gas surplus that has depressed natural gas prices.)

Increased prices for oil and natural gas, combined with expectations of future increases in the price of natural gas, should result in a modest increase in rotary rig counts in 1990. Diminishing resources and slight price increases imply continued cutbacks in domestic drilling for oil. Increased drilling for natural gas should more than offset these cutbacks. Energy extraction employment in the Southwest should grow slightly with the rig count.

Construction Shows Gains in 1989

Although construction contract values and employment remain far below their highs of the mid-1980s, Southwest construction showed gains in 1989 (Chart 4). Gulf Coast petrochemical plant construction, as well as modest increases in home and apartment building, started a turnaround during the summer. The upswing was not large, but it is promising.

Chart 4
Construction Contract Values in the Southwest, Five-Month Moving Average

As Chart 5 shows, construction employment increased during most of the year, but estimated fourth-quarter 1989 employment numbers fell slightly below those of a year earlier. Growth in the region's construction employment should continue throughout 1990.

The industry faces some negative factors. Vacancy rates for office buildings remain quite high. New regulations for thrifts increase the

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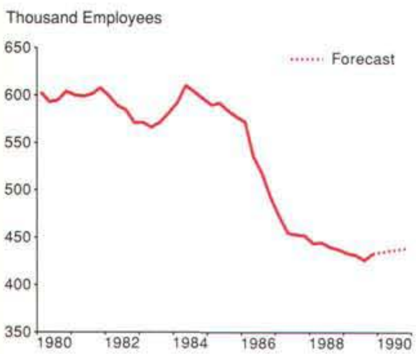
Chart 5
Construction Employment in the Southwest, 1980–90



difficulty of obtaining construction loans for some homebuilders. Contracts for building petrochemical plants peaked in 1989 and will decline in 1990, although existing contracts will sustain growth through the year.

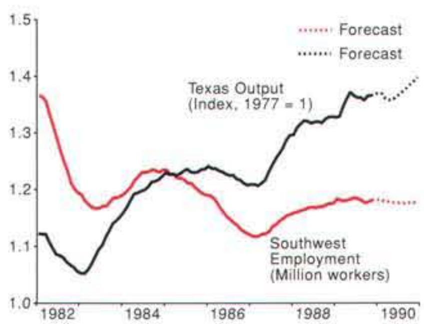
More positive than negative factors are evident. Louisiana will increase its state expenditure on highway construction. In some large Southwest cities, falling apartment vacancy rates and increasing rents signal a possible increase in construction of multifamily housing. Declining interest rates suggest an expansion in homebuilding. The Southwest will even see a few office building projects begin in 1990.

Manufacturing Will Slow Despite Some Gains

For the past several years, manufacturing growth contributed greatly to the Southwest's economic recovery. In the first half of 1989, both manufacturing output and employment accelerated (Chart 6). In the second half of the year, manufacturing weakened, largely as a result of a sharp decline in the durable goods industries.

During 1990 growth in several manufacturing industries will slow. The electronic and semiconductor industries will remain weak. Decreased growth in defense spending could add to weakness in high-tech industries and soften the demand for transportation equipment. Slower growth in business investment at the national level should reduce the demand for many types of business machinery produced in the Southwest. Slower growth in exports and domestic consumer spending also could weaken the demand for many consumer goods, such as textiles and apparel.

Chart 6
Manufacturing Performance in the Southwest, 1982–90



A few industries will expand this year. Although growth in petrochemicals may slow, the industry will continue to be a strength in the region's manufacturing sector. Rubber and plastics products and oil field equipment also should grow in output and employment.

On the whole, manufacturing growth will slow somewhat. Real output should increase about 2 percent in 1990. Much of the growth in output will occur in capital-intensive industries. Hence, manufacturing employment is likely to fall by 0.3 percent.

Service-Producing Industries Weaken Slightly

The service-producing sectors are quite diverse; they include finance, insurance and real estate (FIRE); government; transportation, communications and public utilities (TCPU); business, professional and personal services; and retail and wholesale trade. Much of the income and employment in the service-producing industries of the Southwest depends on sales to and income generated in other areas of the region's economy. Even so, the Southwest exports a growing portion of the services produced in the region to other areas of the United States and to foreign countries.

Until 1985 when lower oil prices and the construction bust dampened the region's service-sector growth, service-producing employment in the Southwest grew at about the same rate

Chart 7
Service-Producing Employment in the United States and in the Southwest, 1982–90

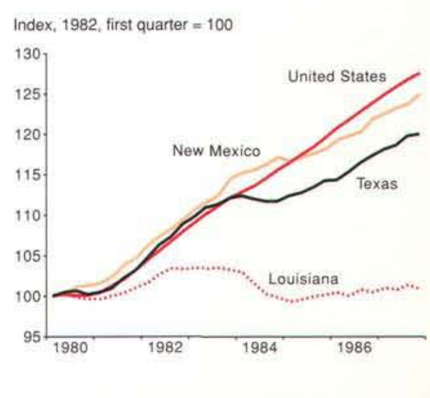
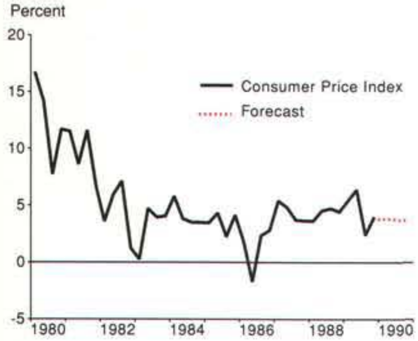


Chart 4
Inflation



(continued from the inside panel) adjusted interest rates in the United States and real interest rates abroad (Chart 5). During the third quarter, a much narrower interest-rate differential accompanied a stable dollar. In the fourth quarter, as U.S. interest rates dropped below interest rates available overseas, the dollar fell.

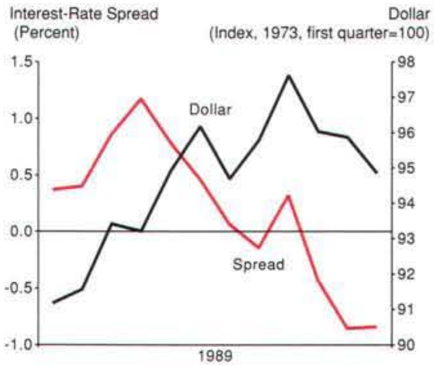
The Year Ahead

Economic growth will continue in 1990, but at a somewhat slower annual rate of 1.7 percent (Table 1). Consumers will increase their purchases more moderately than in 1989. For businesses, slower growth in sales and narrowing profit margins will reduce both the incentive and the ability of firms to undertake new investment projects, reversing last year's trend. Also in contrast to 1989, lower mortgage rates will encourage a partial recovery in residential construction. The recent reduction of international tensions, combined with political pressure to meet Gramm–Rudman deficit limits, will result in a further slowing of growth in government purchases. Growth in net exports is likely to stall. Weak growth in the overall demand for U.S. products should translate into a modest easing of the upward pressure on prices. Consequently, the rate of inflation should fall to 4.1 percent in 1990.

Considerable uncertainty surrounds the trade outlook. Several factors suggest continued improvement in the trade deficit. The weakening of the U.S. economy relative to those of its trading partners should slow growth in demand for imports of materials and supplies. In addition, the relatively weaker U.S. economy, the looming economic unification of Western Europe and the relaxation of trade barriers between Eastern Europe and the West suggest that the investment climate in Europe will become increasingly favorable compared to that in the United States. U.S. imports of capital goods may decline, and U.S. exports of capital goods may increase.

But there are other indications that the trade deficit will deteriorate. Domestic savings tend to fall when the U.S. economy slows. The reduced availability of domestic credit forces U.S. borrowers to turn to foreign sources of funds. In the international trade accounts, a deterioration of the trade balance implies increased overseas borrowing.

Chart 5
Real Interest-Rate Spread and the Real Trade-Weighted Value of the Dollar



The real value of the dollar is likely to remain roughly constant in the early part of 1990. Later in the year, as real interest rates overseas rise again relative to real interest rates in the United States, the dollar may begin to drift downward.

Exchange-rate movements in the coming year, like adjustments in the trade balance, are subject to a great deal of uncertainty. Improvement in the political situation in Europe put downward pressure on the dollar in the fourth quarter of 1989. Further declines in the dollar are possible if investment opportunities in Europe develop more rapidly than expected. An acceleration of the move toward more restrictive monetary policy overseas would also put downward pressure on the dollar.

Summary

The outlook for the U.S. economy in 1990 is more of the same. Growth in gross national product will fall slightly from a drought-adjusted 1.9-percent annual rate in 1989 to a 1.7-percent annual rate in 1990. Consumption, nonresidential investment and government purchases will slow somewhat. Only residential construction is likely to improve. Progress in the fight against inflation will be difficult.

Net exports are a wild card. Ordinarily, net exports would stall at this stage in the business cycle. But political developments in Europe may promote an investment boom there—a boom that would put downward pressure on the dollar and fuel demand for U.S. exports.

—Evan F. Koenig

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