

Crossroads

ECONOMIC TRENDS IN THE DESERT SOUTHWEST

El Paso Economy Sluggish in 2007: U.S. Slowdown Outweighs Fort Bliss Expansion

This has been a disappointing year for El Paso in terms of job growth. Through October, the city added only 1,200 new wage and salary jobs, according to seasonally adjusted data, an annualized growth rate of less than 1 percent.¹ The seasonally adjusted unemployment rate remained at a historically low level of 5.4 percent in October, but progress in lowering the rate further stalled at midyear.

El Paso's job growth over the past decade has had a strong positive correlation with the U.S. business cycle (*Chart 1*).² El Paso's industrial roots and continued economic ties to the Mexican maquiladora industry keep the city closely linked to the U.S. factory system. A broad slowdown in U.S. growth—jobs grew at a 1.1 percent rate through October—has been under way for over a year and provides the backdrop to sluggish local growth.

However, some elements of El Paso's economic performance are specific to the city. For example, the major factor behind lower U.S. growth is the housing bust, an event whose effects vary widely in markets across the country, and El Paso has its own story to tell. Further, economic neighbor Mexico has broken out of the mold of mechanically following the U.S. business cycle, with surprisingly good growth continuing in that country. And the maquiladora industry has at least held its own across the border in Ciudad Juárez, with job growth flat in recent months. Finally, El Paso has high expectations built up by the Fort Bliss expansion. It is an economic boom that is still waiting to happen; the stimulus is unfolding more slowly than initially forecast.

Housing Turns Down

U.S. economic growth slowed in the middle of 2006, with the gross domestic product expanding at annualized rates of 2.4, 1.1, 2.1 and 0.6 percent in consecutive quarters. Growth bounced back in the second and third quarters of this year to around 4 percent but is widely expected to slip back to near 2 to 2.5 percent in coming quarters. Sluggish auto sales and a major downturn in the housing market are the major reasons for the diminished pace of economic growth. On average, over the last five quarters the

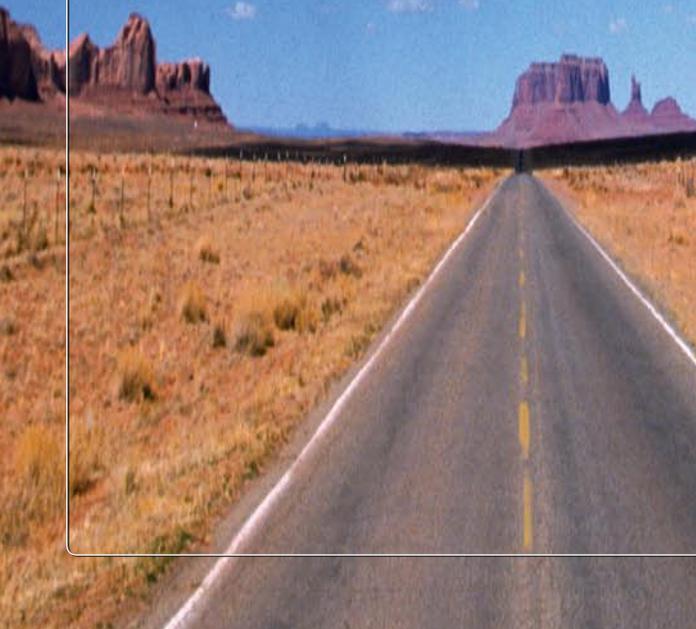
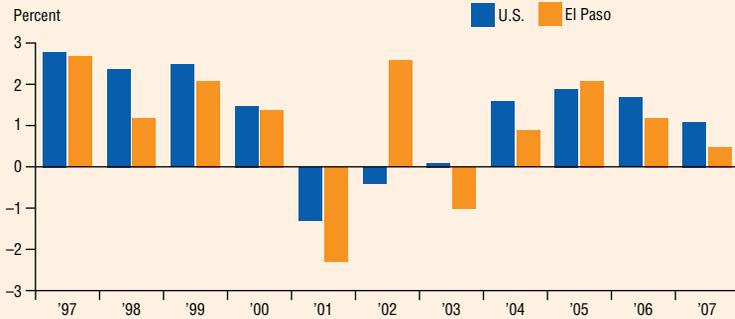


Chart 1
Job Growth in El Paso Slows Along with U.S.



NOTE: December-to-December growth; 2007 through October at annualized rate.

SOURCE: Bureau of Labor Statistics, with adjustments by the Federal Reserve Bank of Dallas.

decline in residential investment alone has subtracted nearly 1 percent from GDP growth.

The housing downturn unfolded in two steps.

The first stage was a rapid price appreciation in many metropolitan markets, the product of low-interest rates that drove demand, and land-use and building restrictions that limited the supply of new homes in many markets. Price appreciation turned into a price bubble in selected markets, mostly on the East and West coasts, and the bubbles began to burst in 2006 as potential buyers were increasingly priced out of the market.

For example, in late 1999, 43 percent of families in Los Angeles could afford to buy and finance a median-priced home (Table 1).³ By

the third quarter of this year, only 4 percent could do so. New York and Miami follow a similar pattern, while more developer-friendly cities like Atlanta, Houston and Dallas saw limited appreciation relative to income, even in the face of strong economic growth and surging home demand. As these local price bubbles burst, the resulting decline in metropolitan housing markets was uneven across metro areas but big enough in aggregate to be a macroeconomic event, with double-digit declines nationally in new and existing home sales, residential starts and permits.

El Paso was part of the problem. Local home prices jumped 43 percent between 2004 and the third quarter of this year. In first quarter 2004, over 70 percent of

El Pasoans could afford a median-priced home. This fell to less than 30 percent early this year and to nearly 20 percent in the third quarter. Part of the price escalation was local and out-of-town speculation driven by the Fort Bliss expansion.

The second stage of housing problems began in August, when subprime, low-documentation and other high-interest-rate lending was abruptly curtailed as a result of credit problems spreading through financial markets. This high-interest lending had been instrumental in fueling home-price escalation by stretching the normal lending standards and greatly expanding the number of potential buyers. As these financing vehicles disappeared, they sharply narrowed the number of potential buyers.

Table 2 shows the percentage of new mortgages by metro area in 2006 that were originated using high-interest loans, defined as mortgage lending at rates 3 percent or more above the yields on prevailing Treasury securities of similar duration.⁴ Selected major metro areas are listed on the left; regional cities are on the right. Texas border cities, including El Paso, relied heavily on high-interest lending last year and now find a significant fraction of those potential customers excluded from the market.

Table 1
Percentage of Local Families That Can Afford Median-Priced Home

	1999 Fourth quarter	2007 Third quarter
Los Angeles	43	4
New York	55	7
Miami	59	11
Chicago	61	40
Dallas	64	54
Houston	66	47
Atlanta	73	64

SOURCE: Wells Fargo Housing Opportunity Index.

Table 2
Use of High-Cost Mortgages for Originations by Metro Area, 2006

Major cities	Percent	Regional cities	Percent
Detroit	52.94	McAllen	54.25
Miami	50.07	Laredo	49.00
Los Angeles	34.69	Brownsville	47.37
Las Vegas	31.06	El Paso	37.18
Chicago	27.33	Phoenix	30.33
Atlanta	24.37	Tucson	20.14
New York	21.65	Las Cruces	17.44
Boston	19.88	Albuquerque	17.10
Philadelphia	16.74		
San Francisco	13.32		

NOTE: A high-cost mortgage is one that yields 3 percent above prevailing Treasury securities.

SOURCE: Home Mortgage Disclosure Act data, Federal Financial Institutions Examination Council.

Both new- and existing-home sales slowed sharply this year in El Paso, with the top of the market hurt worse than the less expensive end. Existing-home sales were down 21 percent in October versus a year earlier; the number of houses on the market jumped 70 percent in the same period. Builders have pulled back sharply on new construction and, in some cases, are returning lots to developers. As seen in Chart 2, the number of single-family permits issued in El Paso has been falling steadily all year, taking away an important source of recent growth for the city.

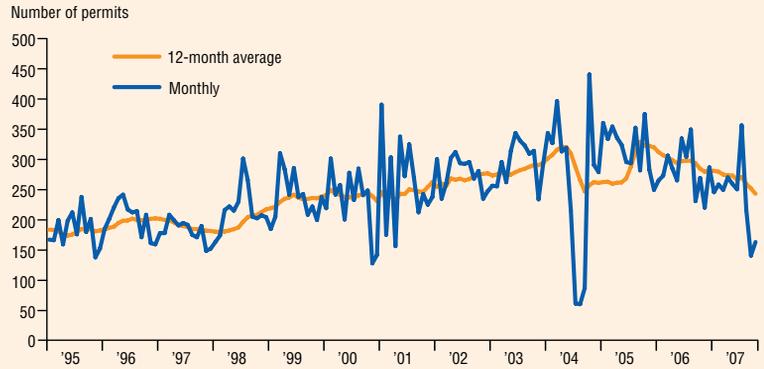
Mexico and the Maquiladoras

Another source of El Paso's slowing economy is the maquiladora industry. Maquiladora employment in Ciudad Juárez in 2006 grew more rapidly than in any other Texas border city, adding over 12,000 jobs. But this year, job growth has come to a standstill as slower U.S. economic growth cast a chill over the Mexican maquiladora system—including Juárez.

Mexico's maquiladoras are intimately tied to U.S. industrial production. Chart 3 shows how U.S. industrial production has driven maquiladora employment since 1990, including the big downturn of 2000–03, when the industry lost nearly a quarter million jobs. The downturn was partly cyclical, coinciding with the 2001 recession in the U.S., but it was also forced by the advent of low-wage competition from China and other Asian, Caribbean and Central American countries.⁵

This low-wage competition forced heavy job losses in apparel, textiles, toys and other low-wage industries. It took several years for the maquiladora industry to work through these losses and find firm footing again in products in which Mexico has a competitive advantage. These include products that

Chart 2
Single-Family Building Permit Trend Down in El Paso



SOURCES: Census Bureau; Haver Analytics.

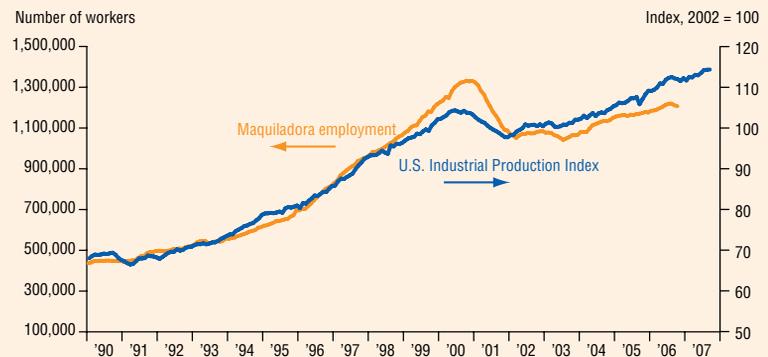
benefit from proximity to the U.S., like big-screen television sets and appliances; products with a high ratio of value-added to labor content, like medical instruments; and products that contain intellectual property to be protected. From 2003 to 2006, maquiladoras again followed the lead of a strong U.S. economy until a cyclical slowdown gripped the industry again this year.

Juárez' maquiladora employment is shown in Chart 4. Mexico's chief statistical agency stopped publishing maquiladora employment as of last October, but a similar data series is available from the Mexican Social Security Institute.⁶ This series (also shown

in Chart 4) is for all manufacturing, but maquiladoras dominate manufacturing in Juárez. This series indicates that employment in Juárez factories turned flat this year and remains in a no-growth pattern.

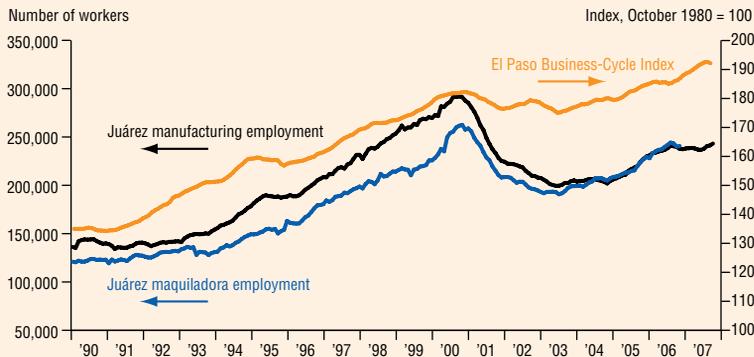
The importance of maquiladoras to El Paso is indicated by the orange line in Chart 4, which shows the Dallas Fed's index of coincident economic activity, a measure of the local business cycle.⁷ El Paso provides myriad services to maquiladoras in real estate, warehousing, transportation, logistics, computer systems, management and other services. This is true for all Texas border cities and their Mexican neighbors; the general rule of thumb is that a 10 percent increase

Chart 3
Maquiladora Employment Mirrors U.S. Industrial Production



SOURCES: Federal Reserve Board; Instituto Nacional de Estadística, Geografía e Informática.

Chart 4
El Paso Follows Maquiladora Industry



SOURCE: Federal Reserve Bank of Dallas; Instituto Mexicano del Seguro Social; Instituto Nacional de Estadística, Geografía e Informática.

in production in a neighboring Mexican city will increase employment in the bordering U.S. city by 1 to 2 percent. This influence is apparent in the pattern of recent changes in El Paso's economic activity. The recent loss of maquiladora momentum means that El Paso has been unable to count on another key source of economic stimulus during 2007.

Mexico is important to El Paso well beyond the maquiladoras, although these manufacturing plants probably stand at the top of the list. General economic stability is important in bringing the Mexican shopper to El Paso. Throughout the decades, about 14 percent of El Paso's retail sales have been to Mexican shoppers, most crossing bridges from Juárez. Economic stability provides confidence to the Mexican consumer and is fundamental to maintaining a strong peso. Mexico's currency has held steady between 10 and 11 pesos per dollar since 2003, with little change in 2007.

Mexico's economic performance has been—and is expected to remain—much better than might be anticipated given a sweeping U.S. economic slowdown. The influence of U.S. industrial production extends beyond the maquiladoras, and it's fair to say that the U.S. has been the major driver of the Mexi-

can economy in recent years. This is because over 90 percent of Mexican exports go to the U.S., and over 80 percent of those exports are industrial products.

However, Mexico has enjoyed solid GDP growth near 3 percent in 2007, and expectations are that this growth will continue and pick up slightly in 2008 (Table 3). This separation from the recent slowdown in the U.S. economy is based on the continued growth of the domestic Mexican economy and strong consumption, driven in part by oil revenues. It is also based on strong exports to Europe that filled in any shrinkage in the U.S. export market (Chart 5). Just as U.S. exports have soared because of a strong dollar against the euro, Mexican exports have followed the same strong path based on a peso/

Table 3
Forecasts for Mexican Economic Growth
(Percent, annual)

	2007	2008
Banamex	3.4	3.8
Bancomer	3.2	3.9
Banco de México*	3.0	3.4
International Monetary Fund	2.9	3.0

*Private domestic and international economic analysts surveyed by Banco de México.

SOURCES: Banamex, Bancomer, Banco de México, IMF.

euro exchange rate that is highly favorable to European buyers.

Fort Bliss

In 2005, the Base Realignment and Closure (BRAC) Commission put a number of West Texas and southern New Mexico military facilities up for review: Fort Bliss in El Paso, White Sands Missile Range near Las Cruces, Holloman Air Force Base in Alamogordo and Cannon Air Force Base in Clovis. Perhaps in testament to the military's need for open land and clear skies for maneuvers, all but one of these regional facilities will remain staffed at pre-BRAC levels.

The only one that won't stay at pre-BRAC levels is Fort Bliss, which emerged as a significant winner in terms of size and employment. The initial plan was to add 11,500 troops and civilian employees to the 8,500 already assigned to the base, bringing total employment to 20,000. This would result from moving the 1st Armored Division from Germany to El Paso, with these gains partly offset by the loss of the Army's Air Defense Artillery School to Oklahoma.

Subsequent announcements have added a combat brigade to Fort Bliss, as well as artillery, aviation and other support units for the 1st Armored. These units will take the initial plan raising Fort Bliss employment by 11,500 to one that adds 20,000 troops and civilians. This would triple the size of Fort Bliss to 30,000 by 2012. The Army is planning a \$2.6 billion expansion on the base for living facilities, headquarters and administrative space, dining facilities, aircraft hangars, barracks and various range improvements. In addition, the city and state are planning and financing extensive road upgrades to improve base access. Local school districts must provide for the 27,000 family members who will accompany the relocating troops.

In 2006, Fort Bliss saw an addition of nearly 4,000 troops. The

bulk of these troops were the result of a newly formed combat brigade under the 1st Cavalry. The net addition of military and civilian jobs in 2007 was fewer than 1,000, and much of this stimulus was likely offset by the deployment of thousands of troops to Iraq. Original plans to have much of the expansion complete by 2010 have been delayed to 2012, and the biggest years for base expansion—perhaps accounting for 14,000 of the 20,000 increase—will not come until 2010 and 2011.

The promise of a significant economic expansion and even an economic boom driven by Fort Bliss remains firmly in place. If we assume that the expansion will add roughly 40,000 new jobs over the long term, both directly at Fort Bliss and indirectly through economic multipliers in the community, this single event adds the same number of jobs as were added from all sources in El Paso during 1997–2005.⁸ The arrival of new military and civilian jobs in El Paso may be slower than originally anticipated, but the wave of infrastructure expansion on the base, on the roads and in the school districts is just beginning. It will provide substantial stimulus for El Paso's construction sector over the next several years.

Also, the expansion carries the promise of new technology jobs

for the city because the Evaluation Brigade Combat Team will be formed at Fort Bliss. This unit will be the test ground for future combat technologies using robotics and information systems, and it should attract an array of military contractors and consultants eager to be near this activity during the test and evaluation process. The city hopes to capitalize on this new nucleus of technology development and testing to form a growing cluster of associated knowledge-based businesses.

Looking Forward

Expectations are high for economic stimulus from the Fort Bliss expansion, but this stimulus arrived too late to avoid a significant economic slowdown in 2007. Sluggish growth in the U.S. industrial sector, a housing downturn that spread to El Paso and a flat year for the maquiladora industry all conspired to pull El Paso's job growth down to less than 1 percent through October.

Improvement should be slow but steady into 2008. The U.S. economy is not expected to lend a lot of help in 2008. The consensus for the year centers on below-potential 2.5 percent GDP growth and an industrial sector that will perform well below the long-run average. But infrastructure expansion at Fort Bliss and the arrival

of another 2,500 jobs on the base should provide enough momentum for a better 2008 locally. The year will remain something of a tug-of-war between slow national growth and Fort Bliss spending.

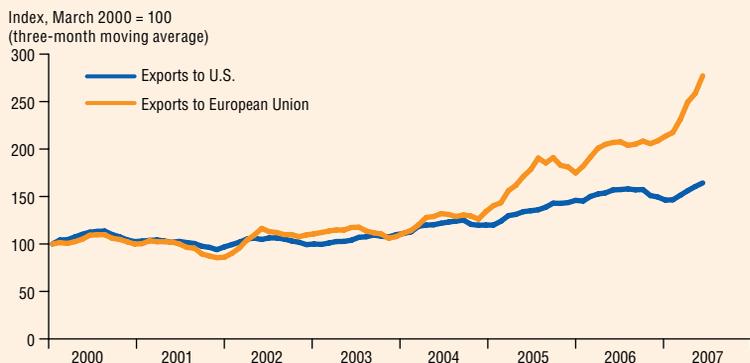
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Notes

- ¹ The payroll job growth cited here does not include military employment but only civilian government jobs. See the discussion later in the article on military employment at Fort Bliss.
- ² Over the previous 10 years, El Paso's payroll employment has averaged only 0.9 percent growth annually, compared with 1.1 percent for the U.S. and 1.9 percent for Texas.
- ³ The definition of median income used in these calculations is taken from the Department of Housing and Urban Development. The methodology changed in 2005, making comparisons before and after 2005 not strictly comparable. For the sweeping changes we are trying to illustrate here, it is unlikely that the methodology difference would alter the picture in a meaningful way.
- ⁴ These figures were compiled directly from Home Mortgage Disclosure Act data for calendar year 2006, which provide high-interest rate lending by metropolitan area. These are for origination of conventional mortgages (excluding government-guaranteed loans) on one- to four-family homes. Refinanced and mobile homes are excluded. See www.ffiec.gov.
- ⁵ For details on the maquiladora's recent history, see "Maquiladora Recovery: Lessons for the Future," by Jesus Cañas, Roberto Coronado and Robert W. Gilmer, Federal Reserve Bank of Dallas *Southwest Economy*, March/April 2007.
- ⁶ See "Mexican Reform Clouds View of Key Industry," by Jesus Cañas and Robert W. Gilmer, Federal Reserve Bank of Dallas *Southwest Economy*, May/June 2007.
- ⁷ This measure averaged a 1.3 percent annual increase over the last 10 years in El Paso, and it has grown at a 1.9 percent annual rate for the first 10 months of 2007. It is a weighted average of changes in local payroll employment, the unemployment rate, real income and real retail sales.
- ⁸ Based on total employment calculations (including military) from the Bureau of Economic Analysis, Regional Economic Information System.

Chart 5
Mexican Exports to Europe Replace Shrinkage in Exports to U.S.



SOURCE: Instituto Nacional de Estadística, Geografía e Informática.