

Crossroads

ECONOMIC TRENDS IN THE DESERT SOUTHWEST

Is the Recession Over in El Paso?

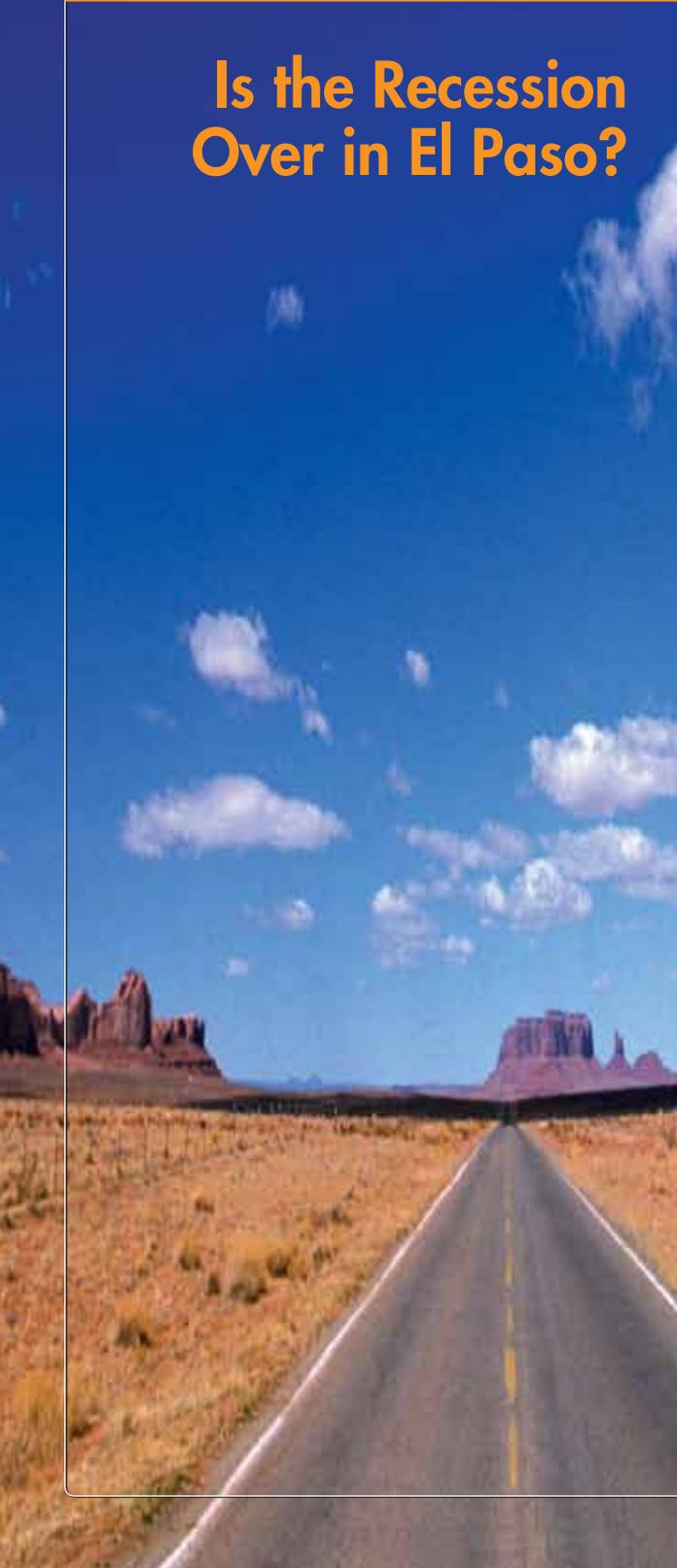
In December 2007, the U.S. economy entered a mild recession, a downturn that would ultimately trigger the worst financial crisis since the Great Depression and a fall into one of the longest and deepest recessions of the past 60 years. Growth returned to the U.S. in mid-2009 but remains too slow to make inroads into stubbornly high unemployment. Virtually no geographic area of the country was left untouched by the U.S. downturn, including El Paso, although the local economy performed much better than other border cities, such as McAllen, Brownsville and Laredo. Government-related spending, especially the huge expenditures at Fort Bliss, provided an important brake on the local economic decline.

This article looks at recent economic trends in El Paso, as well as the prospects for the major economic drivers that combine to determine El Paso's performance. The U.S. economy is growing, especially manufacturing; the maquiladora is hiring again; and the peso has strengthened following the financial crisis. The data clearly point to a recent bottom and to the likelihood that growth resumed early this year. Conditions are now in place for expansion to continue through the rest of this year and beyond.

Update on the El Paso Economy

The broadest economic indicator we have to monitor the local business cycle is a coincident economic index computed by the Federal Reserve Bank of Dallas. El Paso's Business-Cycle Index (BCI) peaked three months after the U.S. in February 2008, declined 5.4 percent, found a bottom in the last quarter of 2009 and grew at a 1 percent annual rate in the first quarter of this year (*Chart 1*). In contrast, the BCI for Brownsville declined by 6.9 percent, Laredo by 19.5 percent and McAllen 13.1 percent; none of these cities show a convincing bottom yet. It was, however, the worst recession for El Paso since an 8.3 percent fall in the early 1980s.

The BCI has four components: payroll employment, the unemployment rate, real wages and real



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retail sales. El Paso's payroll job losses began along with the local recession and accelerated during the financial crisis of late 2008. The decline was relatively mild at 3.1 percent compared with the 6.1 percent loss in the U.S. Job growth has turned back up since mid-2009, but so far the local economy has added only 3,700 of the 8,800 jobs lost to the downturn.

Similarly, the local unemployment rate turned up later than the U.S. rate and did not rise as high, reaching 9.8 percent in March versus 10.1 percent in the U.S. For the first time in decades, the local unemployment rate was consistently lower than that of the U.S., a testament to both the severity of the U.S. crisis and El Paso's resilience. Ironically, as the labor market improves, it will draw discouraged workers back into the labor market, pushing the unemployment rate higher as these workers reenter the workforce. El Paso's unemployment rate rose to 10 percent in April, reflecting this trend.

Real wages in El Paso fell only 1.3 percent in the downturn and were rising once more by third quarter 2009.

Local retail sales fell hard (14.2 percent) with the onset of U.S. recession and devaluation of the peso but turned up at an 8.9

percent annual rate in the third quarter of last year.

All four variables in the BCI have bottomed out or begun a tentative turn up. So far, they point to a slow and shallow recovery—much like that in the U.S. To say where we are headed in 2010, we need to look at four key drivers of local economic conditions: (1) the U.S. economy, especially the industrial sector; (2) the Mexican economy and the exchange rate; (3) the maquiladora industry in Ciudad Juárez; and (4) local public spending, especially at Fort Bliss.

The U.S. Economy

The best and broadest measure of U.S. economic growth available is real gross domestic product (GDP), and it indicates a peak in the U.S. economy in fourth quarter 2007. GDP had fallen 3.7 percent by second quarter 2009, turned up in the third quarter and continued to grow through the first quarter of this year. Recovery is not complete, as GDP remains about 1 percent below the 2007 peak. Growth rates of 2.2, 5.6 and 3 percent over the past three quarters are solid but exaggerated by a restocking of inventories at all levels. Fear of the speed of the decline led producers, wholesalers and retailers to avoid restocking their shelves during the downturn and then to make up for the lack of inventory once recovery set in. Putting this transitory inventory adjustment aside, quarter-to-quarter growth has been a much more pedestrian 1.5, 1.8 and 1.4 percent.

If output has begun to grow, we see only very early and tentative signs of a turn in the U.S. labor market. Overall job losses reached nearly 8.4 million jobs, with March 2010 marking the first month of significant job growth since the recession began. Although losses began to slow sharply in mid-2009, it is

Chart 1
El Paso Business-Cycle Index Is Bottoming Out

Index, January 2000 = 100



SOURCE: Federal Reserve Bank of Dallas.

still to be proven that job growth has returned to a positive track. The unemployment rate has improved slightly to 9.9 percent but seems unlikely to fall much further over the course of this year.

The most important U.S. economic indicator for El Paso is industrial production. El Paso is tied closely to the U.S. industrial sector via the maquiladora industry in Ciudad Juárez. When the U.S. industrial sector booms, the maquiladoras get production orders and El Paso benefits. In the recent recession, the U.S. industrial sector took a big hit, declining 15 percent from its peak in December 2007 to the June 2009 trough (*Chart 2*). Since summer of last year, however, industrial production is up 6.1 percent, although the manufacturing sector still has 30 percent of capacity unused. The Institute for Supply Management's measure of new orders (a leading indicator for the industrial sector) signals that the current momentum in the U.S. industrial sector is likely to be maintained through coming months. As we will see, this U.S. manufacturing expansion is now propelling growth in the Juárez and El Paso economies.

The Mexican Economy and the Exchange Rate

The Mexican economy grew slowly during the first half of 2008, but once the U.S. recession intensified with the financial crisis of late 2008, the Mexican economy was pulled into the global downturn. Mexico's output increased by 1.5 percent in 2008 but contracted significantly in 2009—by 6.6 percent. The economic link between the U.S. and Mexico comes through the trade of manufacturing goods. Mexico quickly followed the lead of U.S. manufacturing gains in the second half of last year, as Mexican manufacturing saw output jump 5 percent. GDP posted

an increase of 8.4 percent during the fourth quarter.

The peso-dollar exchange rate is important for El Paso for two reasons. First, the exchange rate is a key determinant of the volume of trade that goes through El Paso, altering relative production cost between the two countries. Second, shoppers south of the border diligently monitor changes in the exchange rate for its influence on the relative price of goods and services in the two countries. According to our estimates, roughly 10 percent of El Paso retail sales can be attributed to Mexican shoppers.¹

Chart 3 shows the responsiveness of total trade and retail sales to changes in the peso-dollar exchange rate. For instance, in late 2008 when the peso started to lose value against the dollar, both total trade and retail sales started to slide.² Total trade has increased 46 percent between May 2009 and March of this year, mainly due to economic recovery but helped by a weaker peso. El Paso retail sales declined roughly 17 percent and started to bottom in the first half of 2009.

With the crisis over, we have seen the peso once more strength-

Chart 2
U.S. Industrial Production Expanding Vigorously

Index, January 1998 = 100*

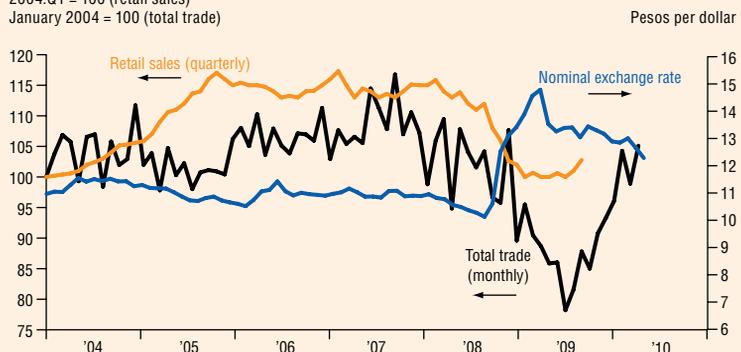


* Seasonally adjusted.

SOURCE: Federal Reserve Board.

Chart 3
Retail and Wholesale Trade Quite Responsive to Exchange Rate

Index*
2004:Q1 = 100 (retail sales)
January 2004 = 100 (total trade)



*Seasonally adjusted.

NOTE: Local retail sales data are quarterly and the last data available correspond to third quarter 2009.

SOURCES: Texas Comptroller of Public Accounts; Texas Center for Border Economic and Enterprise Development; Instituto Nacional de Estadística y Geografía.

en against the dollar. Three reasons can be offered for this renewed strength: The peso probably fell too far during the panic surrounding the financial crisis; the continued zero-interest-rate policy in the U.S. makes Mexico attractive for capital inflows; and Mexico is seen as part of a group of developing nations now leading the global recovery. These recent improvements in the value of the peso mean much better prospects for El Paso retailers.

The Mexican economy is expected to grow moderately over the next two years at a 4 percent rate, and if the peso maintains its value against the dollar in the coming months, the El Paso economy should in turn benefit.

Ciudad Juárez and the Manufacturing Connection

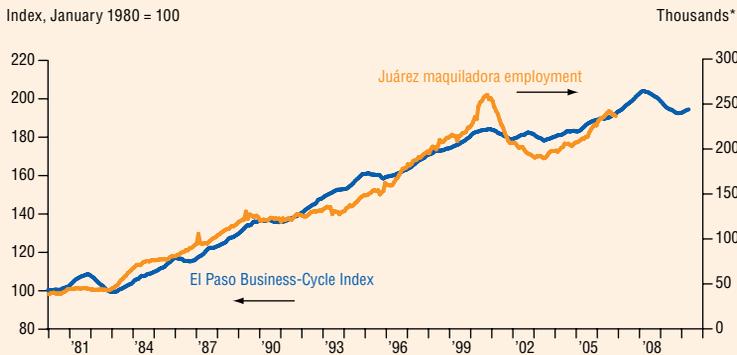
Juárez maquiladoras are of special importance to the El Paso economy. Chart 4 illustrates how closely the El Paso economy has followed the maquiladoras over the past three decades. The relationship exists via a ricochet effect that begins with U.S. industrial activity picking up, followed by new production orders being sent to Juárez maquiladora plants and then economic benefits flowing back

across the border into El Paso. What are these benefits? El Paso supplies a wide array of goods and services to the maquiladora industry. In recent years, maquiladora-related services have come to dominate El Paso's cross-border activity, including accounting and legal services, transportation, logistics, warehousing services and real estate, just to name a few of the most important sectors.

To better understand the impact maquiladoras have on El Paso, we recently updated and estimated some basic cross-border elasticities between output in Juárez maquiladoras and employment in El Paso.³ According to our estimates, a 10 percent increase in output in Juárez maquiladoras translates into a 3 percent increase in nonfarm employment in El Paso. We further estimated the cross-border maquiladora impact by industry. Table 1 summarizes the results, which indicate that the bulk of the impact falls on services sectors, while the manufacturing sector is actually hurt by Juárez maquiladoras. This result is no surprise, given that many of the manufacturing jobs that previously supplied the maquilas with inputs, such as plastic injection molding and metal stamping, have migrated to

According to our estimates, a 10 percent increase in output in Juárez maquiladoras translates into a 3 percent increase in nonfarm employment in El Paso.

Chart 4
El Paso Economy Is Well Anchored to Juárez Maquiladoras



* Seasonally adjusted.

SOURCES: Instituto Nacional de Estadística y Geografía; Federal Reserve Bank of Dallas.

Juárez over the years. It has been one more step in El Paso's evolution from a low-wage manufacturing center dominated by apparel production to a service provider for the maquiladoras in Juárez and northern Mexico. This should be good news to El Paso because these services typically pay higher wages than manufacturing.

Considering the impact maquiladoras have on El Paso's economy, it is crucial to understand trends in that industry. Unfortunately, Mexico's Instituto Nacional de Estadística y Geografía stopped publishing maquiladora data in early 2007, making it difficult to keep abreast of current developments.⁴ To partially fill this gap, we built an econometric model—based on the U.S. industrial production index and Chihuahua state manufacturing employment—to track Juárez maquiladora employment post-2006.⁵ The model indicates that local maquiladoras resumed hiring in August 2009 after almost two years of payroll contraction (*Chart 5*). Anecdotal evidence corroborates this recent uptick in maquiladora employment: Many plants are reporting that orders are increasing and that workers are being called back and rehired. Furthermore, the Juárez maquiladora association recently estimated that the local plants could add 40,000 jobs this year. If these jobs materialize, they would wipe out all losses since the last employment peak in the summer of 2007.

Fort Bliss: the Local Safety Net

In 2005, the Base Realignment and Closure (BRAC) Commission announced that El Paso's Fort Bliss military base would survive the study intact. More important, as part of a major reorganization and consolidation of Army facilities, Fort Bliss would become a major growth center. The base is scheduled to receive an influx of troops beginning in mid-2010 and completed by 2013, ultimately representing an increase in local

population of 57,000 if spouses and children are included. As a result, there have been significant expansion projects inside the base to accommodate the incoming troops and their families, as well as expansion of the city's roads, highways and schools.

During 2006–09, more than \$3.2 billion was spent, with 40 percent going to local contractors. Last year's investment alone—roughly \$1.5 billion—would equal close to 6 percent of the local gross domestic product. For the period 2010–12, Fort Bliss annual expenditures will drop to \$500 million, but just as the spending slows, soldiers and families begin to arrive in large numbers. The stimulus continues but will shift from base construction to housing, retail and other sectors related to

a large population increase.

Although overshadowed by the Fort Bliss expenditures, other notable investments have taken place—a major expansion at the University of Texas at El Paso, an expansion of the medical school and its hospital, as well as important highway interchanges. The El Paso economy benefited from the timing of such government-related expenditures, which provided a cushion against the worst U.S. recession of the past 60 years.

After the Storm

The recent recession in El Paso was the worst since 1981–83. However, the local downturn was less serious than in peer cities along the border and most major cities in Texas. It could have been a perfect storm for El Paso: a huge

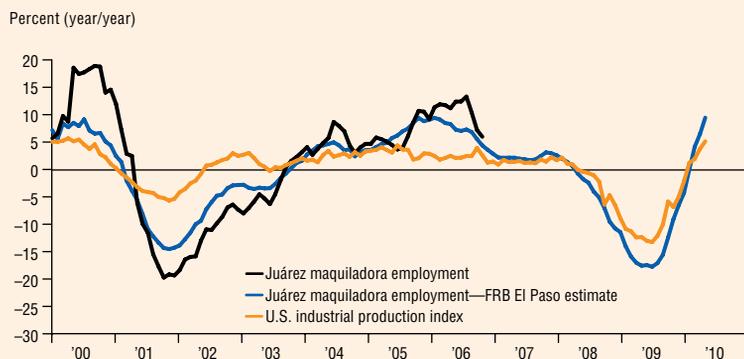
Table 1
Impact of Juárez Maquiladoras on El Paso Economy

A 10 percent increase in maquiladora output leads to:

- 3.0 percent increase in **total nonfarm employment** in El Paso
- 5.4 percent increase in **transportation services**
- 2.2 percent increase in **finance, insurance and real estate**
- 2.0 percent increase in **services**
- 1.4 percent increase in **retail trade**
- 1.2 percent **decrease** in **manufacturing**

SOURCE: Authors' calculations.

Chart 5
Juárez Maquiladoras Are Growing Again



NOTE: Seasonally adjusted data.

SOURCES: Instituto Nacional de Estadística y Geografía; Federal Reserve Board; authors' calculations.

industrial downturn, recession in Mexico and a major devaluation of the peso. But timely and targeted public spending—most planned years in advance—tempered the storm. Public expenditures, dominated by the expansion of Fort Bliss, were critical in softening the recession's impact on local construction. In addition, the arrival of thousands of families in El Paso, and the prospect of many thousands more in 2010 and beyond, buoyed local home sales and home prices during a national housing crisis.

Current data indicate that El Paso has entered a new phase of recovery and expansion. Both the U.S. and Mexico are growing again, industrial production is expanding in both countries, the Juárez maquiladoras are hiring and the peso has strengthened. All these point to continued growth in 2010 and beyond. Growth may be slower than we would like, and unemployment may remain stubbornly high, but the crisis is behind us and skies look clearer ahead.

—Jesus Cañas
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Notes

- ¹ Note that our estimates represent net exportable retail sales. For more details, see “Exported Retail Sales Along the Texas–Mexico Border,” by Roberto Coronado and Keith R. Phillips, *Journal of Borderlands Studies*, vol. 22, no. 1, 2007, pp. 19–38.
- ² Total trade began the declining trend before the decline in the value of the peso as a result of contracting economic activity in the U.S., in particular in the industrial sector.
- ³ We replicated Hanson's analysis for all border cities with quarterly data for the period 1990–2006. For more details on the methodology, see “U.S.–Mexico Integration and Regional Economies: Evidence from Border-City Pairs,” by Gordon H. Hanson, *Journal of Urban Economics*, vol. 50, no. 2, 2001, pp. 259–87.
- ⁴ See “Maquiladora Data: Mexican Reform Clouds View of Key Industry,” by Jesus Cañas and Robert W. Gilmer, Federal Reserve Bank of Dallas *Southwest Economy*, Issue 3, 2007. Mexico's Instituto Nacional de Estadística y Geografía recently released the new Maquiladora Manufacturing Industry and Export Services data, and such data corroborate our estimated turning points in maquiladora activity.
- ⁵ “Maquiladora Employment: New Data Confirm Pickup in Juárez Factory Jobs,” by Roberto Coronado and Jesus Cañas, Federal Reserve Bank of Dallas *Southwest Economy* (forthcoming).

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