National Economic Outlook: Slow Growth Likely

The national economy grew more slowly in 1989 than during 1988. Still slower growth is likely in 1990. Weakness will be evident in almost every sector of the economy; the rates of increase of consumption, business fixed investment, government purchases and net exports will probably decline. Inflationary pressures, however, will remain strong.

The Year in Review

As Chart 1 shows, growth in real gross national product (GNP) fell from 3.4 percent in 1988 to an estimated 2.4 percent in 1989. GNP measurements adjusted to eliminate the effects of the 1988 drought suggest a more severe deceleration: in the absence of the drought, 1988 GNP growth would have been 4 percent while 1989 growth would have been 1.9 percent. A detailed breakdown of GNP, presented in Table 1, indicates that during 1989 growth increased in only one sector: nonresidential fixed investment. In contrast, residential investment, which rose 3.2 percent during 1988, actually declined in 1989. The rates of increase of consumption and of government purchases also eased relative to 1988, though not dramatically. Meanwhile, an unexpectedly strong dollar limited improvement in net exports.

Slower growth in the demand for output was reflected in a softening labor market. The unemployment rate reversed course and closed at 5.3 percent of the civilian labor force after falling as low as 5 percent early in the year (Chart 2). Since the current economic expansion began seven years ago, growth in private nonfarm employment has averaged 226,000 jobs per month. In the second half of 1989, however, this average fell by nearly 50 percent— to 132,000 jobs per month (Chart 3).

Chart 1
Real GNP Growth

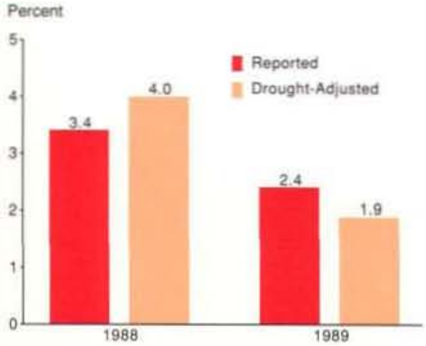
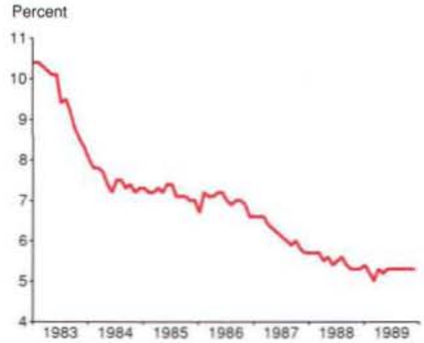


Chart 2
U.S. Unemployment Rate



Sluggish growth hit the manufacturing sector especially hard in 1989. Firms began to cut their work forces and to operate factories at reduced rates of capacity utilization. For the first time since 1985, fewer than 50 percent of manufacturing firms reported slower deliveries—another indication that capacity constraints have begun to ease.

The modest declines in capacity utilization and increases in unemployment observed in the second half of 1989 have thus far had little impact on the rate of inflation. In fact, the rate of consumer price inflation, as measured by the Consumer Price Index, rose from 4.3 percent in 1988 to 4.5 percent in 1989 (Chart 4). Although the rate of increase of consumer prices fell substantially in the third quarter of last year, that lower rate of price increase, it is now clear, was an aberration. In the labor market, wage and benefit cost inflation continues unabated.

Movements in U.S. and foreign interest rates heavily influenced the course of the dollar during 1989. The real value of the dollar rose during the first half of the year, in response to a positive gap between real, inflation-
(continued on the outside panel)

Chart 3
Change in Private Nonfarm Employment

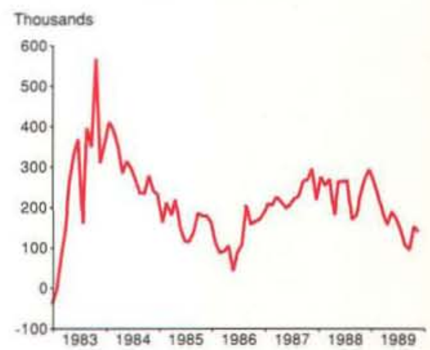


Table 1
Percent Change in Real GNP and Its Components

Sector	1988	1989	1990 (forecast)
Consumption	3.8	2.3	1.9
Nonresidential Fixed Investment	4.2	4.3	2.0
Government Purchases	1.8	0.2	0
Residential Investment	3.2	–6.1	3.0
Exports	13.9	8.8	5.0
(Imports)	(5.3)	(5.9)	(4.0)
Real GNP	3.4	2.4	1.7
Drought-adjusted GNP	4.0	1.9	...

"The effects of a national economic slowdown will be evident in the Southwest during 1990."

as the nation's service sector. As Chart 7 shows, the effects of lower oil prices and depressed construction became most evident in Texas service-producing employment. The service-producing industries in New Mexico also show the effects of lower oil prices. In New Mexico, growth in service-producing employment probably would have outpaced the nation's growth rate had falling oil prices not intervened. Oil-price declines also hindered service-producing industries in Louisiana, a state plagued by a generally poor economic performance in the 1980s.

In 1989, the Southwest's service-producing employment grew an average of 2.5 percent during the first three quarters. Even though last year's average equaled the average for the decade, much of the 1989 growth came from government hiring. Since fourth-quarter 1988, government employment has grown at a 5.5-percent annual rate, while private service-producing employment grew at a 1.5-percent annual rate. For most of the decade, government and private service-producing employment grew at roughly equal rates.

In 1990, growth in total Southwest service-producing employment will be slightly weaker than in 1989. Government employment should accelerate in the second and third quarters of 1990, as hiring begins for the 1990 census and for school restructuring plans in Louisiana and Texas. Growth in private service-producing employment is likely to slow in 1990. Business services, air transportation and government should experience the most growth.

The Implications of Defense Spending Cuts

Concern about the federal budget and recent events in Europe generated broad support for cuts in defense spending. Although the scope and distribution of the cuts are not definite, initial reports suggest spending reductions in the Southwest. Weapons systems produced in the Dallas/Fort Worth area appear to be likely targets. A few bases in the Southwest may be closed or scaled down. Proposed cuts will have little impact on the outlook for 1990.

Most proposals would reduce planned defense spending by 5 percent a year for 10 years, beginning with the 1991 budget. If cuts are uniform, states with a proportionately large share of defense spending probably will face more adverse effects than states with smaller shares. As the economy absorbs funds that would have gone toward defense projects, states with a proportionately small share of defense spending may benefit from the cuts.

Nationally, defense spending accounts for 4.4 percent of output. In the Southwest, defense spending ranges from 3.2 percent of output in Louisiana to 5.9 percent in New Mexico. Defense spending accounts for 4.7 percent of Texas' output. Even without specific details about the cuts, the potential effects of decreased defense spending on the Southwest can be estimated by assuming that the cuts will affect each state in proportion to current defense spending. Each 5-percent cut in defense spending initially would reduce the output in Louisiana by less than 0.2 percent, in Texas by little more than 0.2 percent, and in New Mexico by about 0.3 percent. Local areas of the Southwest that are dependent on the defense industry would be hurt much more than the states as a whole.

Multiplier effects will compound the initial effects of spending cuts. At the same time, however, the economy will reabsorb resources left unutilized by reduced defense spending. For the nation, reabsorption would just about offset the total effects of reduced defense spending. If resources are reabsorbed in proportion to gross state product, Louisiana would gain about 0.1 percent in gross state product in the long run for each 5 percent cut in defense spending. New Mexico would lose about 0.1 percent in gross state product. In Texas, the long-run effects would be negative but negligible.

Southwest Outlook Reflects National Slowdown

The effects of a national economic slowdown will be evident in the Southwest during 1990. The region's economic growth is likely to be somewhat weaker than it was in 1989. Energy extraction and construction should be stronger in 1990 than in 1989, but employment in Southwest manufacturing is likely to slip. The service sector should show a slower rate of growth. These factors will combine to give the Southwest a slower growth rate in 1990 than in 1989.

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