Southwest Outlook Brighter in 1994

Moderate growth characterized the Southwest economy last year, but the region maintained its economic lead over the nation for the fourth consecutive year.[1] Nonfarm employment rose 2.2 percent in the Southwest but only 1.8 percent in the nation. Texas saw broad-based growth across its industries and regions, but job growth was uneven across the Southwest states. New Mexico showed the greatest strength, with a more than 4.5-percent increase in employment, while Louisiana's 1.2-percent increase was less than job growth in either Texas or the rest of the nation (*Chart 1*).

Many of the factors that caused the Southwest economy to outperform the nation's in 1993 will continue in 1994. Construction and construction-related activities should again have strong growth in 1994. Industries with ties to Mexico were strong in 1993 and should get a boost from a stronger Mexican economy and passage of the North American Free Trade Agreement (NAFTA). In addition to these factors, the region should benefit from a strengthening national economy.

However, low oil prices are a cloud on the horizon. If the recent drop in prices is sustained, the energy sector will lose jobs. Assuming lower oil prices are sustainable, employment in the Southwest likely will grow in the 2- to 2.5-percent range this year, ahead of national employment growth but only slightly better than in 1993.

Variation Within the Region

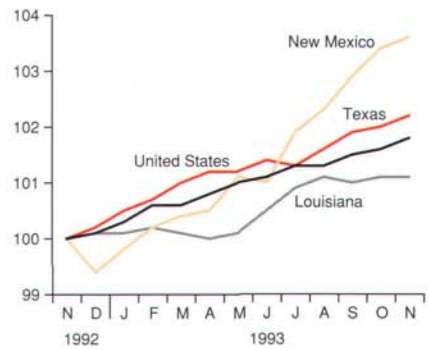
Although the Southwest region as a whole outperformed the nation in 1993, there was a marked difference in the performance of Texas, New Mexico and Louisiana (*Chart 2*).

The primary factors behind the strength of the Texas economy were strong construction activity, exports to Mexico and a stable energy industry (*Chart 3*). Construction and construction-related industries were strong throughout the year. Texas' total contract values were nearly 10 percent above 1992 levels every month in 1993. Low interest rates, stable home values and favorable demographics continued to fuel strong growth in single-family home construction last year. Industries that rely heavily on Mexico as an export market were strong despite a slowdown in Mexican economic growth. These industries include mining; paper and allied products; stone, clay and glass; fabricated and primary metals; rubber and plastics; and transportation services.

However, growth was not confined to the construction sector and industries related to Mexican exports. Manufacturing employment was strong overall. The current strength in manufacturing, especially in consumer and producer durables such as automobiles and machinery, seems to be spurred by increasing consumer and producer confidence.

Chart 2
Growth Across the Eleventh District

Index, November 1992 = 100



Surprisingly, the energy sector was not a drag on the Texas economy last year. High natural gas prices encouraged relatively strong drilling activity in Texas, and low interest rates caused an increase in oil field activity and stable energy-sector employment.

New Mexico posted a better year than Texas. The principal sources of strength in New Mexico were business relocation and expansion, a single-family housing boom and an increase in natural gas produc-

Chart 1
Nonfarm Payroll Employment by State
(Percent Change from November 1992 to November 1993)

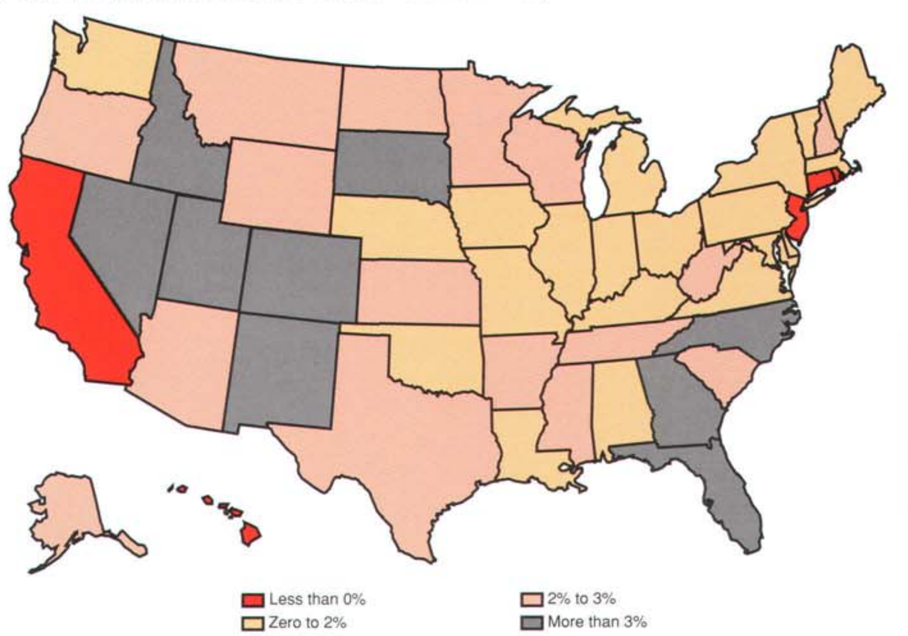
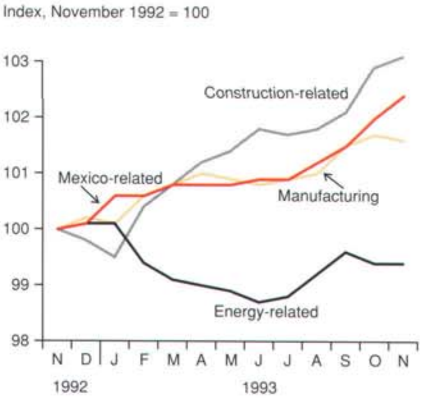


Chart 3
Texas Sectoral Employment Growth



tion. Among the companies either moving to or expanding in New Mexico were Intel, Motorola and Southwest Airlines. Furthermore, some factors that hurt the U.S. economy in 1993—corporate restructuring, defense cuts and slow export growth—had a smaller impact on New Mexico's economy.

Louisiana, on the other hand, is still very dependent on petroleum and chemicals, and when these industries suffer, so does the Louisiana economy. Beginning in late 1991, falling oil prices prompted major movement out of the oil extraction business. Although high natural gas prices offset some of the losses, Louisiana's oil and gas extraction industry continued to lose employment throughout 1993. Also, employment in chemicals, Louisiana's largest manufacturing industry, declined in 1993 because of weak demand both domestically and abroad.

The 1994 Outlook

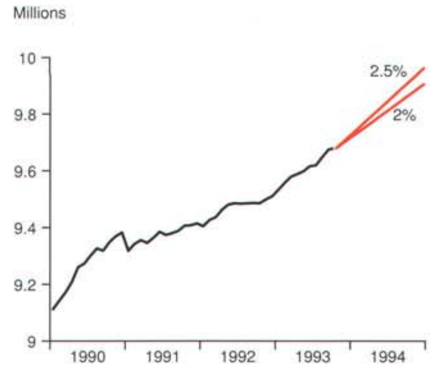
The Southwest likely will see broad-based, moderate growth in 1994, with employment gains in the 2- to 2.5-percent range (*Chart 4*).

The construction industry and industries that export to Mexico, which fueled growth in 1993, should experience similar strong growth in 1994. Single-family homebuilding may slow from the high levels of 1993, but nonresidential and multifamily construction should pick up the slack. Moreover, NAFTA's passage will result in higher spending on infrastructure near the border and boost industries related to Mexico. (See the box entitled "NAFTA and the Southwest Economy.") Growth of Mexico's gross domestic product should reach 3 percent in 1994, up from about 1.5 percent in 1993. A stronger Mexican economy will further boost the Southwest economy.

However, prolonged low oil prices could hurt energy-related manufacturing industries: oil field machinery, primary metals and transportation equipment, such as offshore platforms. Although lower oil prices help the chemical and petroleum refining industries, employment gains in these sectors won't be realized until after 1994. (See the box entitled "Oil Prices and the Southwest Economy.")

Overall, the Texas economy is likely to grow at a 2.2-percent rate this year, with broad-based growth across most industries. New Mexico's rate of job growth will be stronger, at 3 percent. Business expansion and relocation, especially in high-

Chart 4
District States' Employment Forecast



tech industries, will continue to be the primary source of the state's employment growth.

Louisiana probably will grow at a slower rate of 1.1 percent this year, with the construction and opening of casinos the state's primary sources of job growth. Because of Louisiana's continued heavy dependence on the energy industry, any sustained decline in energy prices would be especially painful for the state.

NAFTA and the Southwest Economy

Canada, Mexico and the United States have 15 years to adjust before all aspects of the North American Free Trade Agreement take effect, but already the treaty is creating economic opportunities that could have a big impact on the Southwest economy in 1994. The Southwest is well-positioned to benefit from lower Mexican tariffs on electronics and petrochemical products, two of the region's most important categories of exports.

New trade opportunities got off to a roaring start as the new year began. Before January 1, 17.9 percent of U.S. exports to Mexico entered the country duty-free, compared with 48.9 percent today. On January 1, Mexican tariffs went to zero on about 40 percent of dutiable U.S. exports of electronic equipment. After 10 years, Mexico will eliminate all tariffs on U.S. exports of electronics.

Likewise, Mexico's tariffs on many petrochemical products fell from 10 percent in 1993 to zero in 1994. In fact, under NAFTA customs duties disappear for about 70 percent of the categories of chemicals that had been subject to duties.

The 1994 tariff reductions are only the beginning. NAFTA's full trade opening in services will take years to accomplish, although some types of specialized financial services firms can begin operations in Mexico immediately. As trade barriers fall over time, Mexicans will turn to the Southwest for products that trade restrictions had priced out of their markets, and Southwesterners will do likewise.

Risks to the Outlook

The Clinton administration has an ambitious agenda for 1994, and uncertainty about the details of its proposals could either brighten or darken the Southwest's short-term economic outlook. The administration is considering proposals to reform the health care system through employer mandates, to increase the minimum wage and to offer subsidies to firms that hire welfare recipients. If implemented, each of these proposals would affect employment of low-wage workers. The proposed employer mandates in health care and increase in the minimum wage would reduce employment, while the subsidies for hiring welfare recipients could encourage employment (although firms could reduce their number of minimum-wage workers to be able to hire the subsidized welfare workers). Because Southwestern states have a disproportionate number of low-wage workers, these proposals will have a disproportionate effect on employment in Louisiana, New Mexico and Texas.

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[1] In this article, *Southwest* refers to Louisiana, New Mexico and Texas, the states in the Eleventh District of the Federal Reserve System.

Oil Prices and the Southwest Economy

West Texas Intermediate crude prices have plunged below $15 per barrel in recent weeks, and the price of oil is now at its lowest in five years. Real oil prices are at 1973 levels.

Sustained lower oil prices would hurt the Southwest economy but help the national economy. As Chart A illustrates, a change in oil prices has always had an impact on the Southwest economy. Rising oil prices in the 1970s contributed to strong economic growth, the oil-price crash of 1986 sent the Southwest into recession, and the short price surge after the Gulf war allowed the region's economy to skirt the national recession.

Chart A
Real Oil Prices and District States' Employment

NOTE: Detrending data eliminates the time trend but leaves cyclical fluctuations such as business cycles.

Although the Southwest economy depends less on oil than in the past, the industry is still one of the region's driving forces. And each sustained dollar decline in oil prices lowers Southwest employment by approximately 23,000 jobs.

There is reason to believe that oil prices in the current range are sustainable in 1994. Demand for oil is relatively weak because of slow world economic growth. OPEC has trouble curbing production to quota levels. New seismic technology has caused a drop in oil production costs. And the possibility of Iraq's reentering the oil market has increased.

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